The inevitability (or not) of death and taxes

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They say there are only two certainties in life – death and taxes. Death, clear-cut, I'd agree. But with tax comes nuance: let's take a closer look at superannuation death benefits and tax.

In the late 1970's death duties were abolished in Australia, however, a form of them remains in relation to lump sum benefits paid from a superannuation fund in consequence of the death of a member where the ultimate recipient of that payment is not classified as a 'tax dependant'. In this situation the 'taxable' portion of the benefit payment will be subject to tax at the rate of 15%, plus the 2% Medicare levy, a total tax take of 17% (where insurance proceeds are included in the payment it can be as high as 32%).

Before we get any further into the discussion, let's first review an important concept, being, who is a 'dependant' for superannuation law purposes and who is a 'dependant' for income tax purposes, as the same word, 'dependant', has a different meaning under each law.

Firstly, the Superannuation Industry Supervisions Act and Regulations (SIS) set down the prudential rules for superannuation funds. In relation to death benefits, SIS classifies this event as a compulsory cashing event (SIS regulation 6.21), that is, a member's benefit must be paid, as soon as practicable, in the event of their death.

A superannuation death benefit can only be paid to the member's legal personal representative or a dependant of the member (SIS regulation 6.22(2)). A dependant is defined in section 10 of the SIS Act as "includes the spouse of the person, any child of the person and any person with whom the person has an interdependency relationship". It also includes any other person who was 'financially dependent' on the deceased just before he or she died (i.e. the common law meaning of 'dependant').

So, from a superannuation regulatory perspective, the balance of a deceased member's entitlement can only be paid to:

- the member's legal personal representative (LPR), in effect, their estate;
- the member's spouse;
- a child of the member (and just to be clear, that's a child of any age – a 64 year old son is still a 'child' of their 84 year old mother);
- any person with whom the deceased member has an 'interdependency relationship';
- any person who was 'financially dependent' on the deceased at the time of death.

Subject to below, a trustee of a superannuation fund cannot pay a superannuation death benefit to a beneficiary who does not fit into one of the above categories. For example, without the below mentioned having an 'interdependency relationship' or being 'financially dependent', the superannuation fund trustee could not pay a death benefit to:

- the brother or sister of the deceased member;
- the parent of the deceased member;

- the niece or nephew of the deceased member;
- a friend of the deceased member;
- a charity, religious institution, or other similar organisation.

Where a person wishes their superannuation entitlements to be paid to one of the above, they would need to first have the trustee of their superannuation fund pay the death benefit to their LPR and then include a provision in their Will for the benefit received from the superannuation fund to be distributed to the preferred beneficiary.

Correctly nominating a SIS dependant

When an SMSF trustee is paying a death benefit, either by following a binding death benefit nomination (BDBN) or exercising their discretion, they need to ensure that the payment will be paid to a SIS dependant. Completing a BDBN that includes a beneficiary who is not a SIS dependent will make that binding death benefit nomination invalid.

This was highlighted in the case of Munro v Munro [2015] QSC 61, where Barrie Munro, a solicitor, completed a BDBN and nominated 'Trustee of Deceased Estate' as his beneficiary on his death. Whilst it seemed clear that Barrie's intention was to have his superannuation death benefit paid to his estate and dealt with under his Will, as he did not use the correct SIS dependant term, being "Legal Personal Representative", the BDBN was deemed invalid, which resulted in his superannuation death benefits not being distributed to his intended beneficiaries. It is noted that Barrie could have also nominated "Executor of Will" or named the Executor(s) of his Will, noting that they were his appointed Executors.

When completing a BDBN, make sure that the SMSF's Trust Deed is followed and the correct terms are used. A common mistake is for a member to write in the nominated beneficiary section of the BDBN "as per Will". This is not a valid dependant for SIS and consequently makes the BDBN invalid.

What if there are no SIS dependants or LPR?

Where the trustee of the superannuation fund has not, after making reasonable enquiries, found either a LPR, or a 'dependant', of the member, SIS regulation 6.22(3) permits the benefit to be paid to any individual person, for example, a brother, sister, parent, niece, nephew, or friend, but not a charity, religious institution, as these are not 'individuals'.

Who can receive a superannuation death benefit payment tax free?

The next question is how the superannuation death benefit will be taxed in the hands of the recipient. Superannuation death benefit payments are received tax free where the recipient is a 'dependant' for income tax purposes. The definition of 'dependant' in the Income Tax Act differs from the SIS definition.

To be a 'dependant' for income tax purposes and receive any superannuation death benefit payment tax free, you need to be either:

- the deceased's spouse or de facto spouse
- the deceased's former spouse or de facto spouse
- a child of the deceased under the age of 18

- a person financially dependent on the deceased
- a person in an interdependency relationship with the deceased.

Whilst the above list is similar to the list for a 'dependant' under SIS, the differences are:

- It includes a child, but only if they are under age 18. So you can pay a superannuation death benefit direct from the superannuation fund to a child of the deceased, however, it will only be tax free if the child was under age 18 or if the child and parent were in an interdependency relationship;

- In addition to a spouse or de facto spouse, it also includes the former spouse or de facto spouse. However, under SIS, a former spouse or de facto spouse is not a dependant and consequently would require the payment via the deceased's estate.

How can my adult child receive my super death benefit payment tax free?

Whilst a child, of any age, can receive a lump sum payment directly from a superannuation fund as a consequence of the death of a member, an adult child will only receive the taxable component of the payment tax free where, for income tax purposes, they are either:

- A 'financial dependant' of the deceased; or
- Were in an interdependent relationship with the member, prior to the member's death.

Of course, any tax free component of a superannuation death benefit payment will be received by the adult child free of any tax.

Dealing with interdependency first, two persons (whether or not related by family) have an interdependency relationship if:

1. they have a close personal relationship; **<u>and</u>**
2. they live together; **<u>and</u>**
3. one or each of them provides the other with financial support; **<u>and</u>**
4. one or each of them provides the other with domestic support and personal care.

Where the two persons satisfy the first requirement, but are unable to satisfy 2 to 4 as either or both of them suffer from a physical, intellectual or psychiatric disability, then they will not be prevented from satisfying the interdependency relationship definition.

When determining whether such an interdependency relationship exists, for income tax purposes, regulations require that all of the circumstances of the relationship between the persons must be taken into consideration, including, where relevant:

- the duration of the relationship; and
- whether or not a sexual relationship exists; and
- the ownership, use and acquisition of property; and
- the degree of mutual commitment to a shared life; and
- the care and support of children; and
- the reputation and public aspects of the relationship; and
- the degree of emotional support; and
- the extent to which the relationship is one of mere convenience; and

- any evidence suggesting that the parties intend the relationship to be permanent.

Further, the existence of a statutory declaration signed by one of the persons to the effect that the person is, or (in the case of a statutory declaration made after the end of the relationship) was, in an interdependency relationship with the other person is also a matter that the regulations state that should be considered.

On the face of it, where an adult child returns home to live, or actually never left the family home, you may consider that they would satisfy the interdependency requirement. However, when taking into consideration the matters outlined in the regulations, you may fall short. The relationship needs to be more than simply one of convenience. It needs to be more meaningful, for example, an adult child has moved home to care for an elderly or sick parent.

These considerations and the evidence required are illustrated in the recent Administrative Appeals Tribunal (AAT) case, TBCL and Commissioner of Taxation (Taxation) [2016] AATA 264 (27 April 2016). This case resulted from a knock back by the ATO of an application for a Private Binding Ruling (PBR) ruling by parents, who had lost their son in a motor cycle accident, as whether they and their son had an interdependency relationship and consequently would receive the son's superannuation death benefit tax free.

The brief background to the case was as follows:

- The son had lived with his parents for all of his life except between 2007 and 2009 when he was undertaking studies interstate;
- Upon the completion of his studies he returned to live at his parents' residence;
- On 5 June 2013 the son was killed in a motorcycle accident. At the time of his death he was 22 years of age and was employed as a pilot;
- The parents had been granted letters of administration of the estate of their son;
- The superannuation scheme of the employer of the son included a life insurance policy. In May 2014 the insurer paid the sum of $500,000 to the applicants in their capacity as administrators of the estate of the son.

The AAT found in favour of the ATO, that is, there was no interdependent relationship between the parents and their son prior to his death. The AAT went through the matters that the regulations require to be considered, as outlined above, and found there to be little to no evidence provided to support there being an interdependent relationship prior to the son's death. However, during the hearing, further materials were provided to support the claim of an interdependency relationship. The additional information was materially different from what was provided as part of the application for the PBR and included material such as the assertion of a close personal relationship, the provision of physical and emotional care, that the relationship was more than one of convenience, as well as public aspects of the relationship. This could not be considered by the AAT and consequently the AAT remitted the application back to the ATO to request the parents to make another application for a PBR. The new PBR application would need to include the additional material to support the matters for consideration, as outlined above, when determining whether an interdependency relationship existed.

The take-out from the case is to ensure that any application for determination of the existence of an interdependency relationship address each of the matters outlined above and provides relevant evidence of such. Further, consideration should be given to the completion of a Statutory Declaration of the existence of such a relationship, as this is specifically one of the matters for consideration.

Now, compare this to an ATO Interpretive Decision (ID), ATO ID 2014/22, which considered whether an adult child was a dependent for income tax purposes and consequently would receive a superannuation death benefit payment in respect of a deceased parent tax free. This ID focussed on whether the adult child was a 'financial dependent' of the deceased, which would also result in them being a dependant for income tax purposes, rather than whether there was an interdependency relationship.

The facts, as outlined in the ID, were the taxpayer (a child of the deceased) was paid a superannuation death benefit on the death of the parent. The taxpayer was over 18 years of age at the time of death. The taxpayer had given up work to care for the terminally ill parent and received no financial support from anyone, other than the parent, during that time.

The ID concluded that the adult child was financially dependent upon their parent, as they were their only source of financial support. It was noted in the ID that the taxpayer (the adult child) also satisfied the interdependency relationship requirement, that is, the taxpayer and the parent had a close relationship; they lived together; the parent provided financial support; and the taxpayer was providing significant care for the parent.

In the end, there is no magic formula for ensuring an interdependency relationship exists. It will be the facts of each case that will determine whether such a relationship exists. Consequently, it is imperative that evidence is collected and provided to support the claim.

The other option for an adult child to be a dependant, for income tax purposes, is where they are a 'financial dependent'. This has been touched on above in ATO ID 2014/22. The ID stated that for a claim of financial dependency, that it is a condition that must exist in relation to the taxpayer (the adult child) at the time of the deceased's death. Again, facts and evidence will be crucial in proving financial dependency.

It appears that the ATO has a very narrow view of what constitutes 'financial dependency' as opposed to what the courts have previously decided.

In Malek's case, a mother and son lived together in a house owned by the mother, which was mortgaged. The mother was on a disability pension of about $8,000 per year, with annual expenditure of $9,100 for food, medication, rates, cleaning, heat, power, telephone, hairdressing and podiatry. Her son contributed $13,500 annually to his mother's living expenses, including food, mortgage repayments, taxi fares, medical expenses, physiotherapy, body corporate fees and insurance. He also attended to repairs and alterations to the home; arranged his shift work so he could drive his mother to medical appointments and borrowed money so his mother could have a holiday in Egypt. The son died and his superannuation benefits were paid to his mother. The ATO would not treat the mother as a 'financial dependant' of the son because the amount she applied from her own resources to pay for the necessities of life was not less than 50% of the total monies required (Mrs Malek's $8,000 per annum disability pension covered more than 50% of her "necessities of life" expenses) and consequently the payment would be subject to the relevant superannuation death benefits tax. The case was taken to Court.

In this case, the test for financial dependency was whether the person relied or depended on the deceased for regular continuous significant contributions of financial support to maintain the persons' normal standard of living, not just necessary living expenses. This is a factual question and the court found in favour of the mother, that is, she was a 'financial dependant' of her son at the time of his death and consequently the superannuation death benefit paid to her was received tax free.

Note, Malek's case was decided prior to the definition of dependant, both under SIS and Tax, being extended to include an interdependent relationship.

The ATO, however, as mentioned, appears to have a narrower view of financial dependency, for income tax purposes. A number of PBRs look at the following in relation to financial dependency:

- Financial dependence occurs where a person is wholly or substantially maintained financially by another person;
- If the financial support received were withdrawn, would the person be able to survive on a day-to-day basis?
- If the financial support merely supplements the person's income and represents 'quality of life' payments, then it will not be considered substantial support;
- What needs to be determined is whether or not the person would be able to meet the person's daily needs and basic necessities without the additional financial support.

There is also a requirement to show a reliance on regular and continuing financial support to meet their day to day living requirements. Finally, you will need evidence to support the facts and the claim for financial dependency, including receipts for expenditure of day to day living expenses.

Not all superannuation death benefits paid to a non- tax dependant is subject to tax

A superannuation death benefit payment received by a person who is not a 'dependant' for income tax purposes may not be totally subject to 15% tax, plus any applicable levy. Only the 'taxable' portion of a superannuation death benefit is subject to tax, where received by a person who is not a 'dependant' for income tax purposes. Any 'tax-free' component is exactly that, tax free in the hands of the beneficiary. The 'tax-free' component is basically made up of after tax contributions that the member has made to superannuation, currently known as 'non-concessional contributions' and previously known as 'undeducted contributions'. Consequently, a common strategy to 'wash' taxable components to tax free, prior to a member dying, is the re-contribution strategy.

Is a re-contribution strategy still relevant?

In short – it can be.

The aim of this strategy is to convert the 'taxable' portion of a member's account balance to 'tax-free'. The greater the extent of a tax-free component means:

- Less tax on benefits paid to a member under age 60;
- Less tax on benefits paid to a 'non-tax dependant' on death of the member.

When implementing such a strategy care must be taken to ensure:

- Benefits can be paid to the member, i.e. the member can access their superannuation;
- Consideration is given to taxation of benefits paid, particularly where the member is under age 60;
- Monies can be re-contributed to the fund – consideration to contribution rules for persons aged 65 and over and the relevant contribution caps;
- The fund has the cash flow to effect the benefit payment or the transaction costs associated with paying benefits 'in specie' to members and the rule regarding a fund acquiring an asset from a member as a contribution in specie.

Further, consideration should be given to the actual benefit of this strategy for the member, particularly where they are over age 60 (as superannuation benefits are received tax free). From a superannuation death benefit tax perspective, the beneficiary of this re-contribution strategy is the member's beneficiary, in most cases, adult child or children, not the member. You will also need to take into consideration the proposed revised new non-concessional cap.

How to avoid tax on superannuation death benefits

Tax will only be applicable on a superannuation death benefit payment where:

1. A payment is made as a consequence of the death of a member; **and**
2. The payment is made to a person who is not a dependant for income tax purposes; **and**
3. The payment has a taxable component.

So, to avoid such a tax:

1. Don't die (I understand that medical science is working on this and making progress); or
2. Make sure you have a beneficiary that qualifies as a dependant for income tax purposes at the time of death; or
3. Ensure 100% of your superannuation benefits form part of the tax-free component; or
4. Have nothing inside of superannuation at the time of death.

Let's discount the first suggestion. The second one would require the member to have a spouse or de facto, child under age 18 or a person who was financially dependent upon them at the time of death or a person with which they have an interdependency relationship. The third option may become difficult to achieve and may no longer be desirable for the member, given the proposed revised non-concessional contribution cap.

The fourth one, having nothing in superannuation at the time of death, can be an option that a member can have some control over. As a person ages, particularly past age 65, consideration can be given to withdrawing superannuation and holding it their own name, where the member has no dependants for income tax purposes and consequently the taxable component of any death benefit payment will be subject to 15% tax, plus applicable levy. By just considering the $18,200 tax-free threshold and assuming an assessable earning rate of 6%, that's around $300,000 of superannuation that can be held in an individual's name, with no personal tax (assuming no other income). Where the $300,000 consisted of 100% taxable component, where there are no dependants for income tax purposes, having this capital outside of superannuation on death is a potential tax saving of $45,000

($51,000 if you include the 2% Medicare levy). Using a 3% assessable earning rate, you double it, a $90,000 tax saving!

Have regular reviews

Given the potential for significant tax to apply in relation to a payment from a superannuation fund as a result of the death of a member, a regular review regime would be prudent. This should be part of an overall estate plan review. Members of superannuation funds should be in contact with their advisers, whether that is their accountant, tax agent, financial planner or solicitor to ensure that firstly, they have a plan to deal with their superannuation upon their death, or prior to such death, whether that plan still meets their needs and wishes. Further, they should also have an understanding of the taxing implications of any superannuation death benefit payment to the intended beneficiaries and what are the options to reduce or eliminate that potential tax burden.

As an adviser, assisting your current client in the transfer of wealth from one generation to the next upon their death and preserving that wealth by reducing tax can lead to a continuation of the client relationship to the next generation.