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Over this time he has developed a passion for technical strategy particularly around superannuation, social security and insurance planning. His previous experience in advisory technical support includes developing and delivering professional development seminars, preparation of advice and responding to ad-hoc technical queries from advisers.

DEALING WITH DEATH IN THE NEW WORLD

Josh Rundmann

With the raft of super changes which parliament recently passed, there have been some smaller amendments which have a profound impact on the way pensions will operate when it comes to death, post 1 July 2017. Through some deft changes, the way death benefits are to be treated beyond the current financial year has changed significantly.

What is the current state of affairs?

When someone passes away, their super benefit is to be cashed 'as soon as practical' in favour of a dependant in either the form of a lump sum death benefit, or a death benefit income stream where the beneficiary is a spouse, financial dependant or a minor child. If a death benefit income stream is commenced, during what is referred to as the 'prescribed period' being the longer of six months from date of death or three months from grant of probate (or longer in some select cases), any lump sum paid from the pension will be treated as a death benefit. After this period however, commutations can be made from the death benefit income stream and treated as member benefits – effectively treating the commutation as having come from the pension owner's own funds.

This has two main impacts:

- Lump sum withdrawals after the prescribed period do not receive the concessional tax treatment of a death benefit lump sum.
- It is possible to rollover a death benefit income stream for a spouse after the prescribed period, as a rollover is a super lump sum which is also a member benefit. Once rolled over, the money is in effect indistinguishable from funds contributed by the member directly, and can be blended with their existing super benefits whilst remaining unrestricted non-preserved.

Under the current system, it is not possible to rollover a death benefit under tax law, meaning generally spouses who are receiving a death benefit income stream are 'locked in' to the income stream provider the deceased was using at the time of their death. Once the prescribed period had passed they could choose to rollover their benefit; however this would result in giving up the potentially concessional tax treatment of the death benefit income stream pension payments.

What has changed?

The amendments remove two crucial components to the current rules:

- The 'member' restriction has been removed from the rollover requirements – meaning death benefits can be rolled over, and
- The ability to treat death benefits as member benefits has also been removed – meaning a death benefit will always be a death benefit.

The first change is positive, particularly for people who are not happy with the super provider their deceased spouse was using immediately prior to passing away. Another common example is when a couple were running a SMSF and one has passed away. The surviving spouse may not want to continue with the SMSF on their own, but if they wish to receive a death benefit income stream they will have to wait until the prescribed period has passed before they can wind up the SMSF – and even then rolling over the death benefit to a member benefit may result in additional taxes to be paid on future pension payments due to the loss of the concessional tax treatment of death benefits. Going forward, it will be possible to rollover the death benefit income stream to a new provider, so long as they cash the

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rollover as a death benefit (i.e. commence a death benefit income stream or pay a death benefit lump sum).

The second change is the removal of an exemption that is no longer required since it was designed to solve the problem created by a rollover having to be a member benefit. However in practice this will lock death benefits into either a retirement phase pension, or force the capital out of the super system. As noted above, currently commutations after the prescribed period are treated as member benefits, which allow them in some cases to be rolled back into the accumulation phase indefinitely. Going forward this will not be possible.

Whilst moving death benefits back into accumulation is not an overly common practice, this was an option for a spouse who did not currently need the pension payments but may still benefit from the accumulation phase tax rate on earnings. In addition to how death benefits are treated under the transfer balance system however, this change has removed a potential planning tool to help clients manage their affairs should their spouse pass away.

Death benefits and the transfer balance cap

The treatment of death benefits in the transfer balance system is interesting. Death benefit income streams result in credits to the beneficiary's transfer balance account, however the specifics vary depending on specific circumstances. At a high level, the treatment of death benefit income streams depends on the following:

1. Is the beneficiary an adult reversionary to the existing pension?
2. Is the beneficiary and adult who elected to receive a death benefit income stream?
3. Is the beneficiary a minor child?

For adult beneficiaries who receive a reversionary pension, the transfer value is the balance on the date of reversion – which is generally the date of death. However, the date this credit arises in the beneficiary's transfer balance account is 12 months after the date of death. Hence giving reversionary beneficiaries time to be able to appropriately plan their financial affairs, seek advice, and manage transfer balance credits and debits to avoid an excess being created – of course assuming they are aware of the fact the credit will arise within 12 months of death.

However, for adult beneficiaries who choose a death benefit income stream to be paid under a non-reversionary nomination, the transfer value and credit are both determined on the day that income stream commences. Given a super trustee is required to cash a death benefit as soon as practicable, this can put time pressures on non-reversionary beneficiaries to ensure they know how much of the death benefit they are able to fit under their existing transfer balance account. In theory this information will be made readily accessible by the ATO – however that infrastructure may not be in place at 1 July 2017.

These changes work against higher net wealth families using super as an estate planning or intergenerational wealth transfer tool. By counting death benefits to the surviving spouse's transfer balance cap, and removing the ability to rollover death benefits as member benefits back into accumulation phase, the surviving spouse may need to consider rolling back their own personal pension, in full or in part, to accumulation phase to maximise the amount of the death benefit kept in the super environment.

What options can be considered?

Given the changes are creating tighter restrictions around the amount of funds a widow or widower can keep in super after the death of their partner, alternatives may need to be considered. If a spouse has the ability to receive a death benefit pension but may run into transfer cap issues, consideration would need to be given to rolling back their existing personal pensions to accumulation phase – however this may not create sufficient space within the transfer balance account for the full cashing of the death benefit. If the amount of the death benefit credit is greater than the spouse's remaining pension interests plus any unused cap space, at least part of the death benefit will need to be cashed out to avoid a transfer balance cap issue.

Practical considerations can entail whether there is an overall benefit in maintaining a relatively small balance in a separate death benefit pension – given this capital cannot be combined with the member's own money, fees may become an issue within products that do not have a fee aggregation model.

For people receiving a death benefit income stream before 1 July 2017, they will need to consider whether their circumstances would be more advantageous by commuting their death benefit income stream before 1 July 2017 to convert this to a member benefit (allowing the death benefit to be combined with their personal funds, including being rolled back to accumulation phase) or whether the changes from 1 July 2017 may actually benefit them, by say allowing them to rollover their income stream to a new provider without losing the death pension tax benefits.

Child death pensions

There are specific rules for dealing with death benefit income streams paid to minor beneficiaries – which are substantially different to those for adults where the death benefit is paid after 1 July 2017.

Existing child death benefit pensions in place before 1 July 2017 will be assessed as per the standard transfer balance rules, so child death benefit pensions will be subject to the $1,600,000 general transfer balance cap. However, after 1 July the new rules limit children from receiving more in a death benefit income stream than what the deceased parent was using, or was able to use.

When a child receives a death benefit income stream commencing after 1 July 2017, it is a retirement phase income stream and consequently a transfer balance account is created. However, their transfer balance cap will be nil rather than the general transfer balance cap. Instead of using the general transfer cap, children receive 'increments' in their transfer balance cap which are dependent on the parent's use of retirement phase income streams.

If a parent passes away with no transfer balance account, any minor child beneficiary can receive a death benefit income stream – however their transfer value cap will be increased by the general transfer balance cap at the date of death, proportioned by the child's entitlement to the death benefit.

For example, if a death benefit is to be paid 50% to a spouse and 50% to a child on 1 July 2017, the transfer balance increment (and the maximum amount the child could put in a death benefit income stream from this parent's death benefits) would be $800,000 (50% of $1.6m).

If the parent had a transfer balance account, the child's transfer balance increment is calculated as the deceased's retirement phase income stream asset values on date of death, proportioned to the benefit payable to the child. For parents who have both accumulation and pension interests this means a minor child beneficiary would only be able to receive the appropriate proportion of the deceased's pension as a death benefit income stream.

Note the test is whether the parent has a transfer balance account – not whether the parent has an active retirement phase income stream. In the case where the retirement phase income stream is substantially or completely depleted towards the end of the parent's life, commencing a child death benefit pension may not be possible or realistic regardless of any funds invested in the accumulation phase.

Once the death benefit income stream is cashed out, the child's transfer balance account is effectively deleted from tax records. This is done to make sure children are not impacted in their own retirement by receiving a death benefit income stream during their youth.

What are our options for children?

These changes to child death benefit pensions definitely give cause to review current and future estate planning arrangements, and may necessitate a full review of an individual's estate plan. If it is not possible to leave the funds in super, parents may be concerned about having a significant sum of capital sitting in a bank account to which the child becomes entitled on their 18th birthday. Additionally, earnings on those funds sitting in the child's name would be subject to tax at the penalty rates for minors.

Alternative structures such as testamentary trusts or super proceeds trusts may become increasingly useful in helping manage this capital. Although not as effective as maintaining investments in a completely tax-free environment, these structures allow children to have the investment return taxed at adult tax rates, and also allows for greater control over access to the capital. Generally a death benefit income stream would become accessible to a minor when they reach age 18 and forced out of the super system at age 25, whilst a testamentary trust or super proceeds trust can control access to the super death benefit with greater flexibility to potentially protect child beneficiaries from their own actions. This can reduce the potential of the child coming into significant wealth at an age where they may not be adequately equipped to manage capital in a prudent manner.

The main difference between a testamentary trust and a super proceeds trust is who receives the death benefit. A super proceeds trust is set up for the exclusive benefit of a child of the deceased, and as such the trustee of the super fund can pay a death benefit in favour of the child by paying a lump sum into the trust. For tax purposes, it is important that the funds are paid directly from the deceased's super interest into the trust; otherwise the ability to have earnings on trust capital taxed at adult rates in the child's name is unlikely to be available. Effectively the super proceeds trust receives the child's death benefit lump sum, and as the child would be also considered a tax dependant the lump sum paid would be tax-free.

A testamentary trust, however, directs capital to the deceased's estate whereby it will be dealt with according to the Will. Whilst this solution may be simpler – particularly if the Will already has testamentary trust provisions available to the executor – it could come with a higher level of downsides.

Firstly, the super death benefit is paid into the estate, and as such is subject to both challenges to the Will and creditors to the estate potentially reducing the value of the estate, including the super benefits. Secondly, depending on the structure of the Will the benefit paid from super may, in part, be paid to other beneficiaries who may not be dependants for tax purposes. Both of these negatives may result in the estate having fewer funds to hold in the testamentary trust than if a separate super proceeds trust was used, but for some clients the simplistic structure going forward may outweigh these potential consequences.

Conclusion

These changes around death benefits are continuing to re-enforce the idea that super is not a vehicle for extensive estate planning or intergenerational wealth transfer, however the additional complexity these rules introduce are likely to create a potential minefield for clients when reviewing their estate planning arrangements. Before 1 July 2017 advisers and clients will need to understand both the short term opportunities as well as the longer term impacts of these changes, and potentially modify their death benefit arrangements and estate planning arrangements to be 'future friendly' **FS**

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