

# Child Account Based Pensions & Testamentary Trusts



***Understanding the range of options available in proper estate planning is vital to ensuring that the client's needs are met. In this article, the advantages and disadvantages of considering either superannuation child account based pensions or using the Will to create testamentary trusts are considered.***

## **Who will be the death benefit beneficiaries?**

Superannuation legislation changes commencing as from 1 July 2007 have redefined which beneficiaries can receive death benefits as income streams.

The "sole purpose test" determines the ways in which retirement benefits are to be provided to a member or to the dependants of a member upon the death of that member. The definition of the "dependants" of a member has been expanded by the *Same Sex Relationships (Equal Treatment in Commonwealth Laws - Superannuation Act 2008)* to now include same-sex couples and children of same-sex relationships.

Therefore, a superannuation "dependant" now includes the following:

- a spouse (which includes, a person who, although not legally married to the member, lives with the person on a genuine domestic basis in a relationship as a couple, and whether same-sex or mixed-sex couples);
- a person in an interdependency relationship with the member;
- a child (including an adopted child, a step-child or an ex-nuptial child, regardless of whether they were financially dependent on the member);
- any person who is financially dependent on the member (includes persons who are fully or partially dependent upon the member).

While additional rules apply to the children of a member, an income stream can only be paid to a dependant of the member. Therefore, an income stream can only be paid to a child of the member if, at the time of the member's death, the child is:

- under the age of 18 years
- aged between 18 years and 25 years and is financially dependant upon the member, or
- is aged 18 years or older and suffers from a disability

An income stream paid to child (who is not disabled) of a member can only be paid until the child reaches the age of 25 years. When the child attains the age of 25 years, the income stream must then be commuted and any residual capital is paid as a tax-free lump sum in accordance with s 303-5 ITAA 1997. However, note that an income stream being paid to a disabled child can continue to be paid indefinitely.

There has been mention in some quarters of seeking to create a relationship of financial dependency between grandparents and grandchildren on the basis that the age limit of 25 years does not apply to grandchildren. Therefore, the reasoning is, pensions can be created for the minor grandchildren that would continue to be paid beyond the age of 25 years and still receive the tax-concessional status discussed below.

## **Child Account Based Pensions: tax issues**

The tax legislation determines how a benefit is taxed. For example, superannuation death benefits dependants are covered by the provisions of s 302-195 ITAA 1997 that states such dependants include:

- the deceased member's spouse\* or former spouse (including same-sex spouse)
- the deceased member's child (including children of same-sex relationships) aged under 18 years

- a person with whom the deceased member had an interdependency relationship just before he or she died, or
- a person who was dependant upon the deceased member just before the member's death

An income stream paid to a member's child upon the death of the member will be taxed as follows:

Age of original owner at death	Age of beneficiary upon reversion	Taxation of income (taxed scheme)
60 or older	60 or older	Tax-free (s 302-65 ITAA 1997)
60 or older	Under 60	Tax-free (s 302-65 ITAA 1997)
Under 60	60 or older	Tax-free (s 302-65 ITAA 1997)
Under 60	Under 60	Tax free component is tax free (s 302-70 ITAA 1997), taxable component is taxed at MTR and is subject to a 15% tax offset (s 302-75 ITAA 1997), but is tax-free when beneficiary reaches age 60 years

A pension paid to a child will only be paid until the child reaches the age of 25 years (unless that child is permanently disabled). Commutation before the child reaches the age of 25 years or when the child attains the age of 25 years means that the lump sum will be paid tax-free pursuant to s 303-5 ITAA 1997:

### **303-5(1)**

*A \*superannuation lump sum that you receive from a \*complying superannuation plan is not assessable income and is not \*exempt income if:*

*(a) the superannuation lump sum arises from the commutation of a \*superannuation income stream; and*

*(b) any of these conditions are satisfied:*

*(i) you are under 25 when you receive the superannuation lump sum;*

*(ii) the commutation takes place because you turn 25;*

*(iii) you are permanently disabled when you receive the superannuation lump sum; and*

*(c) you had received one or more \*superannuation income stream benefits from the superannuation income stream before the commutation because of the death of a person of whom you are a \*death benefits dependant.*

### **303-5(2)**

*Subsection (1) applies despite Divisions 301 and 302.*

Note that the provisions of s 303-5 therefore override the provisions of Divisions 301 and 302 relating to "Superannuation member benefits paid from complying plans etc".

Note also that s 303-5 ITAA 1997 is therefore a specific exception to the "rule" set out in the ATO's earlier position expressed in ID 2004/688 entitled *Exempt income - segregated current pension assets*. Although IDs are not legally binding, and can later be revised and even withdrawn, they nevertheless represent the ATO's current position on a particular matter.

In ID 2004/688, the tax-exempt status of pension income would not continue to apply after the death of a sole member who had been in receipt of that pension prior to death. The ATO's view was that the exemption would not

continue to apply after a member's death because the fund assets were no longer used to actually pay a pension. Put another way, when a pension ceased because of a member's death, then the fund's tax-free exemption also ceased.

This means that after the death of a single pension member, a lump sum payment could still be made to a nominated beneficiary or to the legal personal representative of the estate, but such payment could trigger potentially significant tax liabilities. However, due to the inclusion of s 303-5 ITAA 1997 in the amendments that took effect post 1 July 2007, child pensions fell outside of the restrictions of ID 2004/688.

### **Timing of payments:**

Legislation requires that death benefit payments be made "as soon as practicable".

The *Superannuation Industry (Supervision) Amendment Regulations 2007* Reg 6.21(1) states as follows;

- (1) *Subject to sub regulation (3), a member's benefits in a regulated superannuation fund must be cashed as soon as practicable after the member dies.*

However, the definition of "as soon as practicable" is not defined in the legislation. The legal meaning of the phrase "as soon as practicable" is discussed by Pearce and Geddes in their legal textbook *Statutory Interpretation in Australia* (6th ed. LexisNexis Butterworths, 2006):

This expression is a little more flexible than 'as soon as possible'. The length of time permitted is to be judged against what is practicable from the viewpoint of the person or body that has to comply with the requirement having regard to its normal procedures and all other surrounding circumstances. (*Martin v Commonwealth* (1975) 7 ACTR 1)

Some requirements that would be effect the issue of "as soon as practicable" could include emotional trauma, delays in receiving advice from advisers and delays in the preparation of the fund statements of account.

### **Testamentary Trusts: Taxation**

Providing that the Will contains the necessary provisions to establish testamentary trusts, paying superannuation benefits to a deceased estate allows such benefits to be directed to the beneficiaries of a testamentary trust. However, the taxation treatment of superannuation benefits within the testamentary trust depends upon the tax-concessional status of all beneficiaries of that trust. For example, where all trust beneficiaries are death benefits dependants, then the trustee will receive the total benefit tax-free. However, by contrast, where any beneficiary is a non-death benefit dependant, then the full amount of the benefit will be taxed on the same basis as if it had been received by a non-death benefits dependant.

Testamentary trusts are generally discretionary trusts; provide the trustee with the discretion to make tax-effective distributions of income or capital to beneficiaries, and the flexibility to limit distributions to specific chosen beneficiaries.

The ATO classifies income paid to minor children from a testamentary trust classed as "excepted trust income" under s 102AG ITAA36 as such income is taxed at adult tax rates. The penalty rates imposed upon unearned income distributed from family discretionary trusts to minor children therefore do not apply to such distributions from a testamentary trust.

As a result, a minor child can receive income from a testamentary trust of up to \$14,000.00 tax free in each financial year based upon the \$6,000.00 tax free threshold and the \$1,200.00 low income tax offset for the 2008/09 financial year, assuming that the child does not receive income from any other source.

For the sake of the comparison of child account based pensions and testamentary trusts below, I have assumed that all testamentary trust beneficiaries are tax dependants.

### **Example**

Ian, aged 45 years, is divorced, has accumulated superannuation savings of \$600,000.00 (consisting wholly of taxable (taxed) component), and intends to leave his super proceeds to his two children, Jake (14) and David (16).

In considering his estate planning options, Ian notes that his children can either:

- have a child account based pension paid from his superannuation fund, or
- the superannuation benefit can be paid to his estate in order to create a testamentary trust

The tax implications are as follows:

	Annual Pension (minimum)		Income from trust (all income distributed)	
	Jake	David	Jake	David
	\$12,000.00	\$12,000.00		
			\$20,000.00	\$20,000.00
<b>Tax payable</b>	\$900.00	\$900.00	\$2,100.00	\$2,100.00
<b>Less tax offsets:</b> - Pension - LITO	\$1,800.00 \$1,200.00	\$1,800.00 \$1,200.00	N/A \$1,200.00	N/A \$1,200.00
<b>Tax liability</b>	<b>Nil</b>	<b>Nil</b>	<b>\$900.00</b>	<b>\$900.00</b>

In this scenario, the account based pensions will be taxable and the beneficiaries eligible for a 15% tax offset assuming that Ian would be aged under age 60 at the time of his death, that the children would also be aged under 60 years and that the pensions would be payable as death benefits to each child.

However, if the minimum pension were to be increased to an amount equal to the income from the testamentary trust, then the tax implications would instead be as follows:

	Annual Pension (minimum)		Income from trust (all income distributed)	
	Jake	David	Jake	David
	\$20,000.00	\$20,000.00		
			\$20,000.00	\$20,000.00
<b>Tax payable</b>	\$2,100.00	\$2,100.00	\$2,100.00	\$2,100.00
<b>Less tax offsets</b> - Pension - LITO	\$3,000.00 \$1,200.00	\$3,000.00 \$1,200.00	N/A \$1,200.00	N/A \$1,200.00
<b>Tax liability</b>	<b>Nil</b>	<b>Nil</b>	<b>\$900.00</b>	<b>\$900.00</b>

As a result of the comparison between the two sources of income, superannuation allows the child to receive more income in a tax-effective manner.

However, tax should not be the sole consideration for making an estate plan.

#### Other Issues to consider

At first glance, the tax concessions applying to superannuation income streams paid upon death make this option extremely attractive.

However, there are two disadvantages to this approach:

- children who are not under a disability can obtain access to the underlying capital once they have reached the age of 18 years (the rule in *Saunders v Vautier* ( 1841 ) 49 ER 282), and

- the pension can only be paid until the child reaches the age of 25 years, at which time any remaining capital must be paid out as a lump sum

The rule in *Saunders v Vautier* states: where all the beneficiaries a trust have reached adult age and none are under a disability, then they can legally require the trustee to transfer the legal estate to them and wind up the trust. Notably, this rule also applies to trusts created within superannuation funds.

Therefore, in reviewing a client's estate planning goals, taxation will be only one consideration. Some other issues to consider when comparing these options are:

- Control:
  - When should the child get control of the funds?
  - Children from the age of 18 years will have control of an account based pension and can decide to commute it.
  - A testamentary trust allows the capital to be retained for a longer period of time and may even give discretion to the trustee to decide on the amounts and frequency of the payments, and also allows the trust assets to be retained within the family group.
- Special Needs Beneficiary:
  - If the child has special needs, it may be better to prevent the child from getting access to the capital beyond the age of 18.
  - In this instance, a testamentary trust may be a more favourable option, and can be relevant where the child is a spendthrift or has a gambling problem, is alcohol dependant or suffers from a drug addiction.
  - A child who is permanently disabled is eligible to continue to receive an account based pension paid until death. In some situations, a trustee may assist in the administration of the account based pension through the creation of a power of attorney.
- Protection in the event of marriage breakdown:
  - A testamentary trust can still offer asset protection in the event of marriage breakdown.
  - The trust will be treated as a financial resource to the child; however it will not normally form part of the assets of the marriage (unless the child is the sole beneficiary).
- Protection from bankruptcy of the child:
  - This may be important consideration when a child is in a high-risk profession (such as a doctor or a company director).
  - In some respects, while the law is unclear as to the protection extended to amounts held in a superannuation income stream, it is clear that income amounts may be used to repay creditors.
  - However, once the lump sum becomes available it is then possible that this may be received by the child secure from the claims of the Trustee in Bankruptcy.
  - The trustee should have flexibility on the distribution of income and capital if a beneficiary is in this situation.
- Updating the SMSF deed
  - Superannuation regulations are regularly reviewed and amended by Federal government legislation. A self-managed superannuation fund deed must be updated to reflect these changes. Otherwise the fund cannot take advantage of any new rules.
  - Recent changes to legislation that should be incorporated into a deed include:
    - Provisions of the 2007 Simplified Superannuation Reforms
    - Account based pensions
    - Product Disclosure Statement
    - Changes to compulsory cashing benefits
    - Minors allowed as members
  - Some older deeds may not even allow for in-specie contributions or commutation of pensions.

- In order to ensure the pensions are not commuted by any child prior to the age of 25 years, the SMSF trust deed will need to be amended so that pensioners cannot commute their pensions prior to the beneficiary attaining the age of 25 years.
- Maintaining the pension fund balance
  - Should the fund balance drop below a level sufficient to sustain the pension, it may not be financially viable to continue the fund due to accounting and compliance costs.
- Centrelink
  - Account based pensions do not qualify for Centrelink asset test exemptions. Therefore, the full superannuation balance will be assessed under the Centrelink assets test.
- Superannuation Binding Death Benefit Nominations
  - These will provide certainty about who will receive superannuation death benefits upon the death of a member.

## **In Conclusion**

It is worth noting that each of these strategies have their respective advantages and disadvantages.

Ultimately, the most appropriate strategy will depend upon the client's estate planning requirements and the needs of the prospective beneficiaries.

It is also important to regularly review estate planning strategies to take into account changes in legislation or the circumstances of the prospective beneficiaries, particularly when a child is no longer eligible to receive an income stream paid and there may have adverse tax implications upon the receipt of superannuation death benefits.