CHILD ACCOUNT BASED PENSIONS AND TESTAMENTARY TRUSTS

Understanding the range of options available in proper estate planning is vital to ensuring 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 defines which beneficiaries can receive death benefits and income streams.

The 'sole purpose test' determines that a superannuation fund, including an SMSF, is to be maintained so that retirement benefits are to be provided to a member or to the dependants of a member upon the death of that member.

A superannuation 'dependant' 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 child (including an adopted child, a step-child, an ex-nuptial child or a child of the person's spouse, regardless of whether they were financially dependent on the member);
- a person in an interdependency relationship with the member; and
- any person who is financially dependent on the member (includes persons who are fully or partially dependent upon the member).

On the death of a member, their superannuation balance ('superannuation death benefit') can be paid to a dependant, either as a lump sum or, possibly, as an income stream (pension).

An income stream can only be paid to a dependant of the member, with a further proviso that it 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; or
- aged between 18 years and 25 years and is financially dependent upon the member at the time of their death; or
- suffers from a (prescribed) disability.

An income stream paid to a 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 of the ITAA 1997.

An income stream being paid to a disabled child can continue to be paid indefinitely, provided the child is disabled at the later of;

- reaching age 25; and
- the death of the member.

Consideration is sometimes given to 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.

However, our understanding is that the mere payment of expenses is not sufficient to establish financial dependency, so high level advice should be obtained before taking this course.

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 of the ITAA 1997 that states such dependants ('tax 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

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- a person who was dependent upon the deceased member just before the member's death.

An income stream paid to a member's superannuation death benefits dependant upon the death of the member will be taxed as outlined in this table:

Age of original owner at death	Age of beneficiary upon reversion	Taxation of income (taxed fund)
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 Marginal Tax Rates and is subject to a 15% tax offset (s 302-75 ITAA 1997), but becomes tax-free when the beneficiary reaches age 60

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 of the ITAA 1997.

Transfer Balance Cap Issues

The Superannuation Reform legislation from 1 July 2017 introduced the concept of Transfer Balance Caps and, for minor beneficiaries, Modified Transfer Balance Caps.

A Modified Transfer Balance Cap potentially limits the amount of superannuation death benefits which may be paid to a child dependant.

Details of Modified Transfer Balance Caps and the impact on Child Account Based Pensions can be located in a separate article Superannuation Death Benefits – Consider the Children.

In effect, the limitations imposed under the Modified Transfer Balance Cap rules may result in a testamentary trust being the only available option.

What is a Testamentary Trust?

A testamentary trust is a trust which is established under the directions provided in a Will of an individual.

Testamentary trusts are generally discretionary trusts; they 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.

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.

Types of Testamentary Trusts

As mentioned, a testamentary trust is a trust established under a Will and, generally, it is structured similar to a discretionary trust – in other words, it has a wide range of potential beneficiaries, some of whom are not likely to be tax dependants.

A more restricted version, created solely to receive superannuation death benefits, is a superannuation proceeds trust.

Whilst a testamentary trust is established under a Will, a super proceeds trust can also be established under the terms of a Will or else directly by the trustee of a super fund.

The other significant difference between a super proceeds trust and a testamentary trust is that the beneficiaries of a super proceeds trust are restricted to tax dependants.

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Testamentary Trusts: Taxation

Superannuation Benefits

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 tax dependants (i.e. a super proceeds trust), then the executor will receive the total benefit tax-free.

However, by contrast, where any beneficiary is not a tax dependant, then the total benefit will be taxed at 15% on the taxable component of the amount received from the superannuation fund.

Trust Distributions

The ATO classifies income paid to minor children from a testamentary trust as "excepted trust income" under s 102AG of the ITAA 1936.

That means the income is taxed at normal marginal 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 the $18,200 tax free threshold and, possibly the low income tax offset, 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, assume that all testamentary trust beneficiaries are tax dependants.

Let's look at an example

Ian, aged 45 years, is divorced, has accumulated superannuation savings of $600,000 (consisting wholly of taxable (taxed) component) plus $500,000 life insurance cover held by his SMSF on his life, 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 outlined in Table 1.

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 actual pension payments were to be increased to an amount equal to the income from the testamentary trust, then the tax implications would instead be as outlined in Table 2 (overleaf).

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.

	Annual Pension (minimum)		Income from trust (all distributed)	
	Jake	David	Jake	David
Pension	$22,000	$22,000		
Distribution			$30,000	$30,000
Tax payable	-$722	-$722	-$2,242	-$2,242
Less offsets: - Pension - LITO	 $3,300 $530	 $3,300 $530	 N/A $530	 N/A $530
Tax liability	**Nil**	**Nil**	**-$1,712**	**-$1,712**

Table 1

Current as at 26 September 2018.
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Other Issues to consider

Tax should not be the sole consideration for making an estate plan.

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

There are two particular 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; and
- the pension can only be paid until the child reaches the age of 25 years (unless disabled), at which time any remaining capital must be paid out as a lump sum.

Therefore, in reviewing a client's estate planning goals, taxation will be only one consideration. In fact, the tax advantage will cease at age 25, at the latest, unless the child is disabled. Some other issues to consider when comparing these options are:

	Annual Pension (selected amount)		Income from trust (all distributed)	
	Jake	David	Jake	David
Pension	$30,000	$30,000		
Distribution			$30,000	$30,000
Tax payable	-$2,242	-$2,242	-$2,242	-$2,242
Less offsets: - Pension - LITO	 $4,500 $530	 $4,500 $530	 N/A $530	 N/A $530
Tax liability	**Nil**	**Nil**	**-$1,712**	**-$1,712**

Table 2

- **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 amount 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 obtaining 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.
- **Partial access**
  - Although much discussion surrounding access to a superannuation income stream involves stopping early access, there may be occasions where a lump sum is needed, possibly for a school excursion overseas, to purchase a motor vehicle, etc.
  - Partial commutations of a child pension are not permitted - any commutation must be in full.
  - Whilst there is no limit to the amount of pension which may be drawn, the amount drawn is taxed, whereas the lump sum is paid tax free.

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- Ad hoc payments may be made from a testamentary trust, at the discretion of the trustee.

- **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 an 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 to distribute income and capital to a beneficiary in this situation.

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 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 and there may be adverse tax implications upon the receipt of superannuation death benefits.

More information

Should you have any queries or require more information, please contact the team at Topdocs on 1300 659 242.

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