Superannuation 'death tax'

Minimising tax on benefits left to adult children

Dr Brett Davies

When a person dies with money in superannuation two questions arise. Firstly, who does that money go to and how can you ensure that it goes to the people you choose? And secondly, what tax will be payable by the recipients and what steps can be taken to reduce the tax burden?

Taxation of superannuation benefits left to adult children

Most people want to leave their money to their children. In fact, many retirees spend their superannuation frugally so as to leave as much as possible in the fund for their children who they nominate as their beneficiaries.

In Australia, when an older couple dies their children may be in their sixties. At the very least they are likely to be over 18 years old. This is why it is important to understand that adult children are typically subject to tax of 17% or 32% on the superannuation monies they inherit. This is because superannuation death benefits are only tax-free when paid to a person who meets the definition of a 'tax dependant', and adult children generally do not meet this definition.

'Death duties' in Australia

By 1983 all Australian states had abolished death duty and probate duty. Prior to this, taxpayers were subject to up to 27.9% tax on a deceased estate of over $1 million.

While death and probate duties are gone, defacto 'death duties' can still be considered to arise in the form of:

- Stamp (transfer) duty
- Income tax
- Capital gains tax
- Superannuation tax on non-dependant beneficiaries

This article considers the fourth point—the defacto death duty of 17% or 32% which is immediately payable on superannuation when the beneficiaries are non-tax-dependants. This term is defined by tax legislation and differs from the definition of 'dependency' under superannuation legislation.

Superannuation and taxation definitions of 'dependants'

The two separate definitions of 'dependants' are shown in Table 1. The first definition is set out under the *Superannuation Industry (Supervision) Act 1993* (SIS Act). Only dependants who meet these definitions are eligible to receive superannuation death benefits. The second is set out under the *Income Tax Assessment Act 1997* (ITAA 1997). Only dependants under ITAA 1997 can avoid superannuation death tax. In contrast, lump-sum death benefits paid to someone who does qualify as a death benefit tax-dependant are entirely tax-free.

Table 1: Two definitions of dependants

Superannuation dependant:	Tax dependant:
Your spouse or defacto partner	Your spouse or defacto partner or your former spouse
Children of any age	Only children under 18 years old
A person with whom you have an 'interdependency relationship'.	A person with whom you have an 'interdependency relationship' (same definition as superannuation laws)
A person who is financially dependent on you	A person who is financially dependent on you

Note that 'dependants' are only determined at one point in time—and that is at the time of the member's death. So both categories of dependants can receive your superannuation benefits, but only tax-dependants can receive it tax-free.

The Medicare levy

The tax on different components of superannuation paid directly to non-dependants of 17% or 32% includes the 2% Medicare levy. However, the Medicare levy is not payable if the death benefit superannuation is paid to the member's estate through their Will. This is the case even if the non-dependency tax applies, therefore the non-dependency tax rates through any Will are usually never higher than 15% or 30%.

Persons who die in the line of duty

An exception applies to the beneficiaries of a person who dies in the line of duty as a member of the Defence Force, Australian Federal Police, the police force of a State or Territory, or a protective service officer. These beneficiaries are always treated as a tax dependant and therefore never pay the non-dependency tax. The definition of 'in the line of duty' is set out in regulation 302-195A of ITAA 1997.

Three taxing points for superannuation

In the Australian superannuation system, there are three taxing points:

- money may be taxed when it goes in
- money may be taxed when it is withdrawn, and
- taxation is levied on superannuation income.

Tax on contributions

Let's review how money going into superannuation is taxed. There are only two ways to get money and assets into a superannuation fund.

Concessional contributions

If you put pre-tax dollars into your superannuation it will be taxed at 15% and classed as a concessional contribution. Examples of this include contributions your employer makes on your behalf, and contributions you make yourself for which you can claim a tax deduction (for example, if you are self-employed and do not receive superannuation from an employer). Concessional contributions are the ones on which your adult children usually pay 17% or 32% when you die.

Non-concessional contributions

Non-concessional contributions are contributions from money on which income tax has already been paid, for example, from a salary. You can contribute up to $110,000 per year into your superannuation fund as a non-concessional contribution (no-tax deduction is available). In this case, the money going in is not taxed again so there is no 15% tax applicable, and when you die your adult children will not pay any additional 'death tax'.

Who decides who gets your superannuation when you die?

Many clients are concerned about who will decide how their superannuation is distributed when they die, feeling that they should have the full and unfettered right to leave their superannuation to the beneficiaries they choose. Further, many are dismayed to learn that their adult children will have to pay tax on the superannuation death benefits they receive.

Superannuation does not form part of your Will

A Will does not decide who receives your superannuation when you die because superannuation is not an asset of the estate. Rather the following three scenarios illustrate how your beneficiaries are determined:

Trustee of the superannuation fund

Most commonly, when you die the trustee running the superannuation fund or their staff, decides who gets your superannuation. If you have an SMSF with only humans as the trustee (rather than a company) then a child who is the remaining trustee of the SMSF could potentially decide to leave all your superannuation to themselves, and nothing to their siblings.

The superannuation trust deed

The trust deed itself may set out mandatory rules, for instance, it may state that when you die your superannuation must always go to your 'legal personal representative' (LPR). If you have a valid Will in place, your LPR is your executor. In such a case there is no discretion. If members are not happy with this stipulation they would need to transfer to another superannuation fund.

Binding death benefit nomination (BDBN)

The superannuation fund trust deed (whether you have an SMSF or a retail or industry super fund) may give you the right to decide who gets your superannuation at death. This right or procedure is called a binding death benefit nomination— it can expire after 3 years, or it can be non-lapsing which means you do not need to review it as it is valid until you die.

The quote

Superannuation death benefits are only tax-free when paid to a person who meets the definition of a 'tax dependant'—and adult children generally do not meet this definition.

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Death benefits paid as a lump sum versus income streams

Tax dependants can receive your superannuation benefits in two ways—either as an income stream or as a lump sum, however non-dependants can only receive a lump sum.

As shown in Tables 2 and 3, superannuation death benefits paid to tax dependants as a lump sum are tax-free. Benefits paid to dependants as an income stream are tax-free (on the taxed element) unless the recipient is under age 60.

On the other hand, since 2007 superannuation death benefits paid to non-tax dependants as a lump sum are taxed at either 15% plus Medicare levy on the taxed element, or 30% plus Medicare levy on any untaxed element.

Table 2. Death benefit payments to dependants:

Age of deceased	Type of death benefit	Age of recipient	Tax on taxed element	Tax on untaxed element
Any age	Lump-sum	Any age	0%	0%
Aged 60 and over	Income stream	Any age	0%	Marginal tax rate (MTR) less 10% tax offset
Below age 60	Income stream	Above age 60	0%	MTR less 10% tax offset
Below age 60	Income stream	Below age 60	MTR less 15% tax offset	MTR (no offset)

Table 3. Death benefit payments to non-dependants

Age of deceased	Type of death benefit	Age of recipient	Tax on taxed element	Tax on untaxed element
Any age	Lump-sum	Any age	15% plus 2% Medicare levy	30% plus 2% Medicare levy
Any age	Income stream	Any age	Cannot be paid as an income stream	

Financial dependants and 'interdependency'

In addition to a spouse or child under 18 years, there are other circumstances in which someone can receive your superannuation benefits tax-free. This includes persons who meet the definition of a *'financial dependant'*, or are in an *'interdependent'* relationship with you.

Both of these tests are 'snapshot tests' meaning they are determined at the time of your death, and both 'interdependency' and 'financial dependency' will need to be proven.

Interdependency

An interdependency relationship exists between two people (who do not need to be related) if all of the following conditions are met:

- they have a close personal relationship, and
- they live together, and
- one or both provides the other with financial support, and
- one or both provides the other with domestic support and personal care.

All the requirements must be satisfied (except where one person has a disability) as set out under subsection 302-200(1) of the ITAA 1997.

What about an adult child who moves back in with their parents or indeed, never left home? Simple convenience is not enough to demonstrate interdependency. However, an adult child who is caring for an elderly or sick parent may tick the box.

Disabilities

If the deceased or the other party suffered a physical, intellectual or psychiatric disability, there may be an interdependent relationship. For instance, say an adult with a disability was cared for by his parents and then passed away. His parents are not dependants under the superannuation definition, nor are they his financial dependants but they may have an 'interdependent' relationship and be eligible to receive his superannuation death benefits tax-free.

Where the deceased suffered from a disability only the 'close personal relationship' point needs to be satisfied. The other requirements do not need to be met if the reason they are not satisfied is that either party suffers from a disability.

Temporarily living apart

The interdependency relationship criteria can still be met if you have a close personal relationship but are temporarily living apart at the date of death, such as where one person was temporarily working overseas or was in a hospital or jail.

Is my girlfriend a 'tax dependant'?

Your spouse or defacto spouse is automatically a tax-dependant for superannuation. However, is a partner who does not live with you a 'spouse' for superannuation tax-dependency purposes?

Let's consider the case of *Trustee and Guardian v McGrath and others* [2013] NSW SC 1894 (*Trustee and Guardian v McGrath*). Though this case was about a defacto relationship and did not specifically relate to superannuation death tax, it is noteworthy because it found that to 'live together' as a couple, you do not necessarily have to share the same residence.

Facts of Trustee and *Guardian v McGrath*

- The couple, with their respective life spouses, had been friends for 20 years
- Each of their respective spouses died within weeks of each other
- The couple got closer over the next 13 years
- They never lived together in the same residence
- They considered themselves to be a couple and were intimate
- They spoke every night on the telephone
- They met at least a couple of times a week
- They often holidayed together
- They attended family functions together, albeit only on one side of the family as the other side did not approve.

Decision

When one of the couple died, a dispute arose over whether they were in a defacto relationship. The court stated that the matter was borderline, but there was sufficient evidence to support a defacto relationship. The court considered how devoted the couple was to each other, even though they never shared a permanent residence together.

What do we learn from this case?

Although this case did not concern the ATO it illustrates how dif-

ficult it is for the ATO to disprove a relationship—it would be a brave official who chose to cross-examine a person on intimacy.

Further, the case shows that there is no one determinative factor. When considering whether two people are in a defacto relationship, the decision depends on the court's view of the overall circumstances of the case.

Financial dependant

To prove financial dependency the adult child needs to be relying on the deceased person for financial support.

You may think that financial dependence would be easy to prove, given many parents provide support to their children throughout their lives! However, to try and close this loophole the ATO has taken a narrow view by considering the following points:

- is the person 'wholly or substantially' maintained financially by you?
- if your financial support was withdrawn, how would the person survive?
- does your financial support merely supplement the person's income?
- is the financial support merely for a higher 'quality of life'?
- could they meet their daily needs and basic necessities without your additional financial support?
- is there reliance on regular and continuing financial support for day-to-day living requirements?
- what receipts for expenditure and evidence are there for living expenses?

The ATO has a hard time disputing what you tell them and cannot prove what happens in the privacy of your home. Further, the ATO's view on what constitutes 'financial' support may be very different from the court's view. If the court has a different view, it will prevail.

Under 18 at time of death but over 18 when benefit is paid

Although the law states explicitly that the time for testing interdependency and financial dependence is just before the death of the member, the position for spouses and children relies on the ATO's practice.

The ATO states that it applies a similar timing rule for these categories of dependants. This means, for example, that a child who is under 18 when the deceased died is regarded as a dependant. This is the case even if the child is 18 or older when the death benefit is paid to the LPR, as set out in ATO Tax Determination TD 2013/12.

Does the trustee withhold the 17% or 32% tax?

If the superannuation fund is paying the benefits directly to a person, then it determines if the person is a tax dependant. However, if the superannuation fund is paying to the estate, then it does not have to address this question. In the latter case, the executors must determine this.

If the superannuation fund trustee or the executors of the estate decide that a person is a 'non-tax dependant', then they must withhold the 17% or 32% tax (or 15% or 30% in the case of the estate) and remit it to the ATO. Parties should seek legal advice in this scenario.

Minimising death tax on your superannuation

There are some strategies to keep your adult children from being subject to superannuation death tax:

- Ensure your beneficiaries qualify as a dependant for tax purposes at the time of your death.
- Ensure your superannuation benefits form part of the tax-free component.
- Withdraw all your superannuation tax-free before your death (for example, if you are over age 60), although by doing this you would lose the benefit of the tax-free environment.
- Employ a strategy such as directing your superannuation to your estate (LPR) via a binding death nomination and establishing a superannuation testamentary trust in your Will.

It is important to consider superannuation as part of your broader estate planning. Your accountant and financial adviser may be able to assist with strategies to reduce the superannuation tax your adult children have to pay when you die. **FS**