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Estate Planning, Testamentary Trusts, Buy-Sell Agreements and Superannuation¹

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Many people believe that estate planning simply involves working out “who gets what” on the death of a person and then signing a Will to that effect. Where clients have complicated personal relationships, substantial assets and/or complicated investment structures, a poorly considered approach to estate planning may result in a dysfunctional outcome for beneficiaries and in a worse case scenario, may undermine the Will maker's (the testator's) wishes.

Different techniques, considerations and strategies generally need to be employed to ensure that these assets pass onto a deceased's beneficiaries tax effectively and in accordance with the deceased's wishes.

Broadly, a person's assets will comprise:

- (a) personal assets;
- (b) ownership of various business and investment entities; and
- (c) superannuation.

Few clients (and indeed some lawyers) understand that superannuation benefits are generally not governed by a person's Will and that the pay out of superannuation death benefits will be determined by the trust deed of the superannuation fund and any binding death benefit nomination (“**BDBN**”) made by the deceased.

Besides the Will, other documents which may need to be established for an effective estate plan to be implemented may include an enduring Power of Attorney, a BDBN in relation to superannuation and a buy-sell agreement in relation to business interests.

In this publication we summarise some of the issues that arise in implementing an effective estate and succession plan for clients who have complicated personal relationships, substantial assets and/or complicated investment structures.

¹ A copy of this publication can be downloaded from our website at www.mbplegal.com.au

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What factors are relevant in devising a good estate plan?

- 1.1 Estate planning involves dealing with a range of personal, commercial and tax issues. Different personal circumstances throw up different issues.
- 1.2 Issues to consider when devising an estate plan commonly include:

A. Family provision claims under Succession Act 2006 (NSW)

- 1.3 A Will maker should always consider whether a dependant has been adequately provided for in the Will. Failure to do so risks a dissatisfied dependant challenging the Will in the Supreme Court and potentially reducing the deceased estate for all beneficiaries.
- 1.4 The area of family provision claims is a detailed area which will not be explored by this paper. However, an adviser should always be aware of the risk of such claims where inadequate provision is made in a Will for a dependant. With more blended family situations this risk increases.

B. Tax and social security issues

- 1.5 What are the tax consequences of a gift? Whilst there is no death tax, death still has tax implications which if not factored in can produce adverse results.
- 1.6 For instance, pre-CGT assets convert to post-CGT assets on death with a cost base equal to the market value of the asset at the date of death. This is an important rule to know because it can affect how gifts are equalised between beneficiaries. This is shown in the following example.

Example 1

Mother, a widow, owns 2 properties:

- (a) *Ellerston (a post-CGT asset with a market value of \$2M and a cost base of \$250,000);*
- (b) *Lorne (a pre-CGT asset with a market value of \$2M).*

Mother wants to be fair between her two children, Gretel and Jamie.

Does gifting one property to each child achieve this? That is, Gretel gets Ellerston and Jamie gets Lorne.

At face value this seems a fair division of assets since the market value of both assets is the same. However, when tax is factored in Gretel's gift is much less than Jamie's.

Since Lorne is a pre-CGT asset, Jamie inherits the property as a post-CGT asset with a cost base of \$2M (assuming mother dies soon after making her Will).

Gretel inherits Ellerston as a post-CGT asset with a cost base of only \$250,000. If Gretel were to sell Ellerston soon after mother's death this would generate a capital gains tax ("CGT") bill for Gretel of \$406,875² assuming Gretel can claim the 50% CGT discount. This leaves Gretel with net cash of \$1,593,125.³

This compares with Jamie who if he sold Lorne soon after mother's death would receive net cash of \$2M and pay no tax.

To be fair, mother should be advised to either leave a 50% share in each property to each child, or if mother has other substantial assets, then to have a clause in her Will which allows her executors to equalise the gifts between the two children by allocating more of mother's residuary estate to Gretel.

(A similar tax problem arises where one child receives the deceased's main residence and the other child receives an investment property.)

² $(50\% * (\$2,000,000 - \$250,000)) * 46.5\%$.

³ $\$2,000,000 - \$406,875$.



- 1.7 A Will maker also needs to consider whether a gift will trigger adverse social security consequences for a beneficiary who is on government benefits. Old Aunty May may be touched by the sentiment of receiving a bequest, but ropeable about the loss of her pension or health care card which occurs because of the bequest. To avoid these social security issues it is advisable to discuss with Aunty May the potential gift so that she can explore with Centrelink the effect of the gift on her benefits.

C. Death as the ultimate rollover

- 1.8 There is no CGT or stamp duty payable on testamentary gifts. This makes death the ultimate tax rollover since many transactions which are not possible during a person's lifetime because of excessive tax and stamp duty payable, become possible on death.
- 1.9 Death can therefore be used as a way of setting inappropriate asset ownership right; something which cannot be achieved during a person's lifetime because of prohibitive CGT and stamp duty costs.,

Example 2

The Brown Family runs a successful family bakery business. Due to poor advice when they first established the business, Mr and Mrs Brown chose to operate the business from a company, Brown Co. The fact that a corporate structure is used means that the Browns miss out on income splitting opportunities that a discretionary trust provides. Rather, all dividends go directly in equal shares to Mr and Mrs Brown, being the shareholders.

The market value of the business is \$8M and since the business was started from scratch, Brown Co's cost base in its goodwill is nil. It is not possible to restructure the business by transferring it to a discretionary trust as Brown Co's annual turnover exceeds \$2M and the Browns' net asset value exceeds \$6M and so the small business CGT concessions cannot be used. If a transfer was made during Mr & Mrs Brown's lifetimes then a \$8M taxable capital gain would be realised (and there would also be a substantial stamp duty liability of \$425,490).

Death would allow Mr and Mrs Brown to restructure into a trust, tax effectively. For instance, Mr Brown could gift his shares in Brown Co to a testamentary discretionary trust established under his Will. Besides income splitting opportunities the testamentary trust also provides benefits since Mr and Mrs Brown's minor grandchildren can receive income distributions from the trust without being subject to penalty tax rates.⁴ The testamentary trust could thus provide a tax effective way of paying for the grandchildren's private schooling.

D. Business succession planning

- 1.10 Business succession planning is important because the right planning will prevent disputes later on and help preserve the value of the business. This is beneficial not only for the persons who will carry on the business after the deceased's death but also for the deceased's beneficiaries since they can dispose of the deceased's share of the business for an appropriate price, rather than at a rock bottom price generated as a result of disputes. In this paper we look in particular at the role that buy-sell agreements have in ensuring appropriate business succession consequences.

E. Enduring Powers of Attorney

- 1.11 Enduring powers of attorney are important to deal with the situation where an individual becomes incapacitated and cannot make financial decisions for themselves. They allow an individual's attorney to undertake financial transactions for the individual's benefit during their incapacity, this can be important in funding health care needs.
- 1.12 Enduring powers of attorney should be distinguished from enduring guardianships and advanced health care directives which concern a person's medical and lifestyle needs. Powers of attorney are solely focused on an individual's financial affairs.

⁴ Under Division 6AA of the Income Tax Assessment Act 1936 ("ITAA36") which is discussed in more detail infra. {00113834}}



- 1.13 Powers of attorney can be very tax effective in the superannuation context, where an individual is 60 years or over and retired. Benefits paid from superannuation to a person who is 60 years or over, are tax free in the recipient's hands. This produces a decidedly unfair result where the beneficiary of a deceased member's superannuation death benefits may be subject to tax on the receipt of such benefits, when if such benefits were paid out just prior to the deceased's death then no tax would be payable. Such taxation occurs where the beneficiary is not a death benefits dependant⁵ of the deceased member, such as the adult children of the deceased member. An enduring power of attorney may assist in withdrawing benefits from superannuation prior to the member's death, and thus avoiding these taxation consequences. This strategy is explained in the following example.

Example 3

Dennis is 67 years old and a widower. All his children are adults and are successful in business. Being a prudent investor and saver Dennis has managed to amass \$3M in his SMSF which he is happily drawing a pension from in his retirement.

Dennis goes to his doctor and unfortunately discovers that he has cancer and there is a 50/50 chance of survival. Dennis is advised by MBP Legal that if he withdraws his superannuation benefits now he will not be taxed on the lump sum withdrawal. However, if the benefits are paid out to his adult children on his death then they will be taxed on the benefits received at the rate of 16.5% - this produces a tax bill of \$495,000.

Dennis then implements a strategy whereby he withdraws a portion of his benefits from the fund on a tax free basis. The downside of this strategy is that the funds are taken out of the concessionary taxed superannuation environment. To hedge his bets Dennis keeps a sizeable portion of his benefits within superannuation just in case he recovers from cancer, bearing in mind the problems he may encounter later on in trying to make further contributions to superannuation at his age.

To cover the possibility that he may die before he can withdraw these retained superannuation benefits from the fund, Dennis executes an enduring power of attorney and specifically alerts his attorney to his desire that his superannuation benefits be withdrawn as soon as it looks likely that he will die. Dennis' cancer treatment renders him incapacitated and his attorney receives notice that Dennis is at death's door. The attorney then completes a form requesting that the trustee of his superannuation fund pay Dennis' superannuation benefits immediately. Luckily the pay out occurs whilst Dennis is still alive and the proceeds form part of Dennis' deceased estate which is divided amongst his adult children. Importantly since the pay out was made to Dennis whilst he is alive, no tax is payable on the pay out.

This strategy is commonly referred to as the angel of death strategy and really only works where a person knows they are dying.

F. Superannuation

- 1.14 An individual's main personal assets generally comprise their main residence and superannuation. Importantly, superannuation is an asset which does not automatically form part of an individual's deceased estate. Consequently, it is not an asset which a person's Will necessarily governs. To ensure that a person's superannuation death benefits are paid out according to their wishes, you have to review the superannuation fund's trust deed and consider making a BDBN.
- 1.15 Due to brevity requirements we have chosen to focus in this paper on three estate planning topics, namely, testamentary trusts, business succession planning and superannuation death benefits.

⁵ See paragraph 4.14 below for a definition of a death benefits dependant.
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The flexibility of a Testamentary Trust⁶

- 2.1 Where an individual has substantial assets and a family, then generally the tax effective estate planning solution is to draft the individual's Will such that the assets which they would have otherwise left behind to their surviving spouse, be gifted to a discretionary testamentary trust established under the Will. The individual's surviving spouse, children and the entities related to the spouse and children would be named as beneficiaries of the trust.
- 2.2 A discretionary testamentary trust provides the following advantages:
- (a) tax advantages, namely:
 - (1) minor children are taxed at adult rates rather than at the penalty 46.5% tax rates under Division 6AA of Part III of the ITAA36;
 - (2) a discretionary trust allows for income splitting amongst beneficiaries and the availability of the 50% CGT discount on a later disposal of capital assets held by the trust;
 - (b) protection for vulnerable beneficiaries; and
 - (c) asset protection advantages provided that the trustee and appointor (i.e. the controllers) of the discretionary testamentary are chosen wisely.

Children taxed as adults

- 2.3 To prevent children from being used as Mummy's and Daddy's little tax shelter, Division 6AA was enacted into tax law. Broadly, that Division taxes income derived by a minor at penalty tax rates (of up to 46.5%) except in certain situations. Income derived by a child from a testamentary trust is one of these exceptions.⁷ This allows a minor child to receive annual income distributions from the trust tax free up to an amount equal to the tax-free threshold (currently \$6,000) and up to \$80,000 at the 30% corporate tax rate. This compares favourably with a minor child beneficiary's position under an inter vivos trust⁸ who would be taxed under Division 6AA – such a minor child can only receive an income distribution of up to \$3,000⁹ tax free.
- 2.4 The tax benefit provided by a testamentary trust can assist in paying a child's school fees, sporting costs, and music and dance classes. This tax benefit applies to all minor children who are beneficiaries of the testamentary trust and not just a Will maker's children. Accordingly, a Will maker's grandchildren and great grandchildren can receive tax effective distributions from the trust. The following example illustrates the tax utility of a testamentary trust.

Example 4

Michael and Monica are designers who own a successful business through a company called M&M Designs. Their business success has allowed the couple to accrue a substantial investment property and share portfolio worth \$5M. The couple was never given asset protection advice and so this portfolio is owned jointly in their personal names as tenants in common. The couple own their home outright, being a modest mansion on Wolseley Road, Point Piper. The couple own the home in equal shares as tenants in common. Michael and Monica have 3 children:

⁶ Further discussion in relation to the drafting of Wills and the use of testamentary trusts can be found in MBP Legal's publication "21st Century Wills" which can be found at our website: www.mbplegal.com.au

⁷ ITAA36 s102AG(2)(a).

⁸ I.e. a trust established during an individual's lifetime as opposed to a testamentary trust which is established under the individual's Will after their death.

⁹ This reflects the low-income tax offset of \$1350 for the 2009/2010 income year divided by 45% (being the top marginal tax rate). The amount covered by the low-income tax offset changes annually.

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- (a) *Nicholas who is twenty, married and with a 1 year old son, Max. Nicholas' annual income is approximately \$60,000;*
- (b) *Josephine who is ten; and*
- (c) *Alex who is six.*

How should Monica's Will be structured?¹⁰

To ensure the principal place of residence concessions for land tax and CGT apply, Monica would gift her share of the home to Michael on her death. The balance of her assets, being her share of the property and share portfolio would then be gifted to a discretionary testamentary trust.

Whilst placing the properties in the trust will lead to increased NSW land tax – since the \$368,000 land tax threshold is not available to a discretionary trust – this should be weighed up against the benefits of income splitting and asset protection that a discretionary trust provides.¹¹

The surviving spouse would be provided control of the testamentary trust by being named as the trustee and appointor of the trust.

Assume Monica dies shortly after executing her Will and the assets gifted to the testamentary trust. The testamentary trust generates \$300,000 taxable income in the 2009/2010 income year.

If Monica had gifted her share of the property and share portfolio to Michael outright, as opposed to establishing a testamentary trust in her Will, then Michael would be liable to pay \$139,500 tax on the income.¹²

This contrasts with the income splitting options which the testamentary trust provides. Assume Michael as trustee distributes income of the trust as follows:

- (a) *Nicholas - \$20,000;*
- (b) *Max - \$60,000;*
- (c) *Josephine - \$80,000;*
- (d) *Alex - \$80,000*
- (e) *M&M Designs Pty Ltd - \$60,000 for working capital requirements.*

As all these beneficiaries have a tax rate of 30% and the individuals may each claim the benefit of the tax free threshold, this produces a significantly smaller tax bill of \$93,600.¹³ This is roughly half of the tax bill which would otherwise be sheeted home to Michael.

As Max, Josephine and Alex are minors there would be provisions in the testamentary trust to allow their parent/guardian to use their income distributions for their benefit such as for education, sporting and musical expenses.

Arm's length rule

- 2.5 Once a testamentary trust has been established, then care should be taken to ensure that the trust is administered on an arm's length basis with related parties. This is because the testamentary trust exception from Division 6AA's penalty tax rates does not apply where the trust derives income from a non-arm's length dealing.¹⁴
- 2.6 Case law, however, indicates that there is no requirement that the income derived by a testamentary trust and which is excepted from Division 6AA's penalty rates, must be sourced from a deceased estate. A trustee of a testamentary trust may borrow funds to acquire further investment assets if they wish, and

¹⁰ Michael's Will would be structured similarly.

¹¹ It is possible to establish a testamentary trust that satisfies the definition of a "fixed trust" for NSW land tax purposes, however, such a trust is inflexible as it requires beneficiaries to be presently entitled to all the income and capital of the trust. Where land tax is a major concern gifting to a fixed trust or a person outright may be an option, in which case only the share portfolio would be gifted to the testamentary trust.

¹² 46.5% * \$300,000.

¹³ i.e. 31.5% * (20,000 + 60,000 + 80,000 + 80,000) + 30% * 60,000.

¹⁴ ITAA36 s102AG(3).
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the income derived on such assets will be excepted income provided that it was derived on an arm's length basis.¹⁵

The death of post mortem trusts in NSW

- 2.7 Previously, the fact that an individual did not include a testamentary trust in their Will was not a complete disaster. The situation could be remedied by having a Will beneficiary (such as the surviving spouse) transfer part of the property which devolved to them under the Will, to a trust for the benefit of a minor child beneficiary. These types of trusts are commonly referred to as "post mortem" trusts, having been created after the individual's death. Post mortem trusts are not as flexible as testamentary trusts created under a Will because they require the terms of the trust to be such that the minor child beneficiary will eventually acquire the transferred property when the trust ends, before the exception from Division 6AA's penalty tax rates applies.¹⁶ Normal testamentary trusts do not have this capital restriction.
- 2.8 Recent changes to NSW intestacy laws¹⁷ significantly reduce the ability to create tax effective post mortem trusts. This is because the exception from Division 6AA's penalty tax rates is capped for post mortem trusts – the amount of annual income distribution that a minor child can receive without being affected by Division 6AA is equal to the amount that the child would have otherwise derived from property that they would have received under the intestacy laws if the deceased had died intestate.
- 2.9 Previously, NSW intestacy laws provided that if a person died intestate leaving a spouse and children then the spouse would be entitled to the household chattels, \$200,000 and half of the deceased's residuary estate, whilst the children would be entitled to the balance of the residuary estate.¹⁸ This has now been changed such that where a person dies leaving issue who are also the issue of the surviving spouse, then the surviving spouse is entitled to the intestate's entire deceased estate.¹⁹ Effectively this means where the children are also the children of the surviving spouse, a post mortem trust that confers Division 6AA benefits cannot be established for the benefit of such children. It is only where the children are not children of the surviving spouse²⁰ that they will share in their deceased parent's deceased estate – in that case the children will be entitled to the balance of the residuary estate after the surviving spouse's entitlement to personal effects, a statutory legacy (which is CPI indexed and is currently \$350,000) and 50% share of the residuary estate.²¹
- 2.10 The changes to the NSW intestacy laws mean that it is imperative that an individual obtain the correct advice and have their Will drafted correctly including having a testamentary trust the first time around.

Superannuation and life insurance

- 2.11 Assets which can flow to a testamentary trust are not restricted to assets of a deceased estate. Superannuation death benefits and life insurance policies may also flow to a testamentary trust and provide Division 6AA benefits to minor children. However, a key condition that must be satisfied before income derived from such transferred superannuation death benefits and life insurance proceeds constitutes excepted income for Division 6AA purposes is that the child beneficiary for whose benefit the transfer was made, must eventually be entitled to that transferred property.²² This rigid capital requirement has made some Will makers segregate life insurance and superannuation proceeds from their general testamentary trust and instead establish separate testamentary trusts (with this capital requirement) to hold such proceeds. Commonly such separate testamentary trusts are referred to as "superannuation proceeds trusts".

¹⁵ *Trustee of the Estate of the late A W Furse No 5 Will Trust v FCT* (1990) 21 ATR 1123.

¹⁶ ITAA36 ss102AG(2)(d)(ii) and 102AG(2A).

¹⁷ As enacted by the *Succession Amendment (Intestacy) Act 2009* (NSW) which obtained Royal Assent on 9 June 2009 but has not yet been proclaimed.

¹⁸ Probate and Administration Act 1898 (NSW) s61B.

¹⁹ Succession Act 2006 (NSW) s112.

²⁰ I.e. children of a prior marriage or relationship.

²¹ *Succession Act 2006* (NSW) ss113 and 127.

²² ITAA36 s102AG(2A).

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- 2.12 Having a separate superannuation proceeds trust means that the standard testamentary trust in the Will can be drafted flexibly to allow capital distributions to any beneficiary, rather than being confined to just some beneficiaries. The size of the life insurance and superannuation proceeds will be material in determining whether a separate superannuation proceeds trust is established.
- 2.13 The receipt of superannuation death benefits by the trustee of the testamentary trust may have tax consequences depending on who will ultimately receive such death benefits under the trust. Generally, to produce a tax free result it is recommended that superannuation death benefits be distributed to death benefit dependants. The taxation of superannuation death benefits and the operation of superannuation proceeds trusts are discussed further in section 4 of this paper.
- 2.14 The taxation of the receipt of life insurance proceeds will depend on who is the beneficial owner of the life policy.²³ Generally, if the beneficial owner is the deceased and the life insurance proceeds are paid to their deceased estate and passed on through their Will to a testamentary trust, then no tax will be payable on the receipt of the life insurance proceeds by the deceased estate or the trustee of the testamentary trust.

Vulnerable beneficiaries

- 2.15 A testamentary trust is also a useful device to make adequate provision for a vulnerable beneficiary such as a spendthrift, drug addict or mentally ill person. Such a person can be made the primary beneficiary of the trust, but their access to trust income and capital can be limited. This can be achieved by placing control of the trust in the hands of an independent party (i.e. the role of trustee and appointor), or by expressly including in the terms of the trust that such beneficiary cannot benefit from trust capital or can only benefit up to a certain amount of trust capital.
- 2.16 A common concern is that such a vulnerable beneficiary have a roof over their head, but not be able to sell the property and dissipate the proceeds. A testamentary trust may provide the solution to this problem.
- 2.17 Currently the Commissioner of Taxation ("**Commissioner**") has a favourable administrative practice in relation to the main residence exemption and deceased estates whereby he equates the trustee of a testamentary trust to be in the same position as the trustee/executor of a deceased estate.²⁴ This means that currently it is possible for a Will maker to direct that the trustees of their deceased estate establish from the assets of their deceased estate a testamentary trust under which the trustees acquire a main residence for a vulnerable beneficiary. The vulnerable beneficiary would be granted under the Will a right to occupy the residence. To prevent the beneficiary from accessing the capital of the trust, other beneficiaries would be nominated as capital beneficiaries who would receive a share of capital of the trust upon its winding up at the death of the vulnerable beneficiary.
- 2.18 Provided that the vulnerable beneficiary uses the residence as their main residence continuously up until their death, then the trustees of the testamentary trust may later on claim the benefit of the main residence exemption when they dispose of the property upon the vulnerable beneficiary's death.²⁵ Generally this results in the trustees being liable for a small amount of CGT referable to the time period between the date when the vulnerable beneficiary dies and the date when the main residence is sold by the trustees. The possibility of the main residence exemption being claimed is incredibly beneficial for the capital beneficiaries of the testamentary trust who will receive a larger capital distribution at the trust's winding up.
- 2.19 Care needs to be taken in the way that this type of testamentary trust is drafted to ensure that the vulnerable beneficiary cannot end the trust and access trust capital. Provisions should also be made to allow the trustees to acquire an alternative residence in the future as a vulnerable beneficiary's

²³ Item 3 of s118-300 of the *Income Tax Assessment Act 1997* ("**ITAA97**").

²⁴ ATO ID 2006/34 and 2002/126.

²⁵ ITAA97 s118-210(3).
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circumstances change. Provided that such provisions are included in the Will, then the main residence exemption may be claimed by the trustees on the later sale of such an alternative residence.

- 2.20 This beneficial CGT result can also be achieved where the vulnerable beneficiary is provided under the deceased's Will, with the right to occupy a dwelling which was the deceased's main residence just before they died.
- 2.21 It is noted that the Commissioner's practice has not yet been judicially approved and may change at any time.
- 2.22 The placement of a main residence in a protective trust raises NSW land tax issues where the trust is not drafted to meet the requirements of a fixed trust.²⁶ This extra cost may be minimised depending on the value of the dwelling acquired by the trustees.

Example 5

Roger and Miriam have two children, George and Susan. George is 27 years old and has Downs Syndrome. Whilst he is well adjusted into society, he still lives at home with Roger and Miriam. Susan is a high achiever with a successful business. She is, however, married to Jason, the son in law from hell. Accordingly, they cannot rely on Susan to ensure that George's needs will be catered for once they are gone.

Roger and Miriam are getting on in years and they want George to be protected once they are gone and at the very least to have a roof over his head. To achieve these aims Roger and Miriam could establish a protective testamentary trust in their Wills for George which includes provision for the trustees to acquire a residence for George and provides George with the right to occupy the residence for the rest of his life. The Wills are drafted broadly so that as George gets older and requires more assistance, the trustees may be able to dispose of the property and acquire a substitute property closer to medical services, without being subject to material CGT on any gain made on the disposal as the main residence exemption applies to exempt the bulk of the capital gain.

Asset protection

- 2.23 Discretionary testamentary trusts also provide to some extent asset protection. This may be helpful where intended beneficiaries of a deceased estate carry on professional activities or business activities which make them vulnerable to litigation claims. The general reasoning being that since a beneficiary of a discretionary trust has no interest in the trust, but rather only a right to the due administration of the trust, the assets of the trust are protected from unsecured creditors.
- 2.24 Whilst recent case law²⁷ indicates that a discretionary trust is not totally impregnable, the discretionary trust is still the asset protection vehicle of choice due to the equitable barriers (represented by the trustee's and appointor's fiduciary duties to beneficiaries) which a creditor faces in trying to prise assets from such a trust. It is noted that the fact scenarios in *Richstar* and *Spry* were very particular to their situation.
- 2.25 *Richstar* arose out of the Westpoint collapse and concerned an application by ASIC to have a receiver appointed to the defendants' discretionary family trusts. The issue in the case was whether the trust assets could be said to be "property" for the purposes of the *Corporations Act 2001*. ASIC argued that the defendants had a contingent interest in the discretionary trusts which was property. French J (who is now the Chief Justice of the High Court) agreed, reasoning that this was the case where a trust is controlled by a trustee who is in truth the alter ego of a beneficiary because it is as good as certain that the beneficiary will receive benefits from the trust. Accordingly, where a discretionary beneficiary is also the trustee or the director and shareholder of a corporate trustee and/or the appointor of the trust then that beneficiary has effective control and their interest in the trust constitutes property over which a receiver can be appointed.

²⁶ As defined in s3A(2) of the *Land Tax Management Act 1956* ("LTMA"). The concessional trust exception may not apply here because there are other beneficiaries to the capital of the trust who may not be under 18 years, disabled or the subject of a guardianship order as required by the concessional trust definition in LTMA s3B.

²⁷ See *ASIC v Carey (No 6)* [2006] FCA 814 ("*Richstar*") and *Spry; Spry v Kennon* [2008] HCA 56 ("*Spry*").
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- 2.26 *Richstar* suggests that if asset protection is desired then control of the trust (both the appointor role and the trustee role) should lie with an independent person. How far *Richstar* takes one in relation to the erosion of the protection provided by discretionary trusts is as yet unclear. However, it is noted that a court in a later case did state that it did not interpret *Richstar* to say that if a person controls a discretionary trust that they are the owner of the trust property.²⁸
- 2.27 *Spry* is a more difficult case in that it suggests that property of parties to a marriage for family law purposes includes:
- (a) a beneficiary's right to the due administration of the trust and right to consideration as an object of the trust; and
 - (b) the trustee's power to apply the income or assets of the trust.
- 2.28 In *Spry* the wife was able to convince the High Court that assets of various family trusts should be included in the parties' pool of marital assets because of her right as a beneficiary to the due administration of the trust and her husband's power to appoint income and capital of the trust.
- 2.29 Due to the wide powers conferred on the Family Court in relation to property of a marriage and its ability to make orders which bind third parties,²⁹ it is probably true to say that there is no bullet proof protection from a disgruntled former spouse.
- 2.30 The following example illustrates the use of a discretionary testamentary trust for asset protection purposes.

Example 6

Michael is a successful lawyer with a loving wife, Sue and four children. Sue is an artist and her job does not carry the same professional risks. As such the family's home and other substantial assets are owned solely by Sue.

It is noted that this ownership strategy is common despite the presence of sections 139DA and 139EA of the Bankruptcy Act 1966. Broadly those sections permit the trustee in bankruptcy to recover property from a third party where the third party acquired the property as a result of direct and indirect financial contributions from the bankrupt and the bankrupt used or derived a benefit whether directly or indirectly during the examinable period. These sections were introduced into law in 2006 and their actual application has yet to be determined by the Courts.

Currently it is not clear what financial contributions means for the purposes of this section. For instance, if Michael used his earnings to pay for living expenses, allowing Sue to use her artist's income to pay the mortgage on the family home, it is not clear whether this would constitute a financial contribution for Michael.

Accepting that Michael's and Sue's asset protection strategy is not completely flawless, care still needs to be taken in devising their Wills. It would be a disaster if Sue's Will was drafted in the traditional way whereby all her assets are gifted to Michael upon her death. The better approach would be for a discretionary testamentary trust to be established in Sue's Will and her assets be gifted to that trust. Under that trust Michael would have no fixed interest and would only be a discretionary beneficiary. Provided that control of the trust rests with an independent person (as opposed to resting solely with Michael) the testamentary trust would provide Michael with asset protection since he holds no proprietary entitlement in the trust. Land tax will, however, be payable in respect of the main residence but it is a cost of asset protection.

²⁸ *Public Trustee v Smith* [2008] NSWSC 397.

²⁹ Part VIII A of the *Family Law Act* 1975.



3

Business succession planning³⁰

- 3.1 When establishing a business structure one should always keep a weather eye on what the consequences are on exit. This includes both the commercial result desired and the tax consequences of such an exit.
- 3.2 Having a highly complicated business structure can pose problems when dealing with business succession and simplification of a business structure may be one step in a person's estate planning. In the context of a family business, trusts provide a tax effective and very practical pathway for the next generation to take over. Unlike a company structure where control requires a transfer of shareholding triggering CGT and stamp duty, control of a trust can be transferred without triggering CGT via a change of trustee and appointor. Stamp duty can also be minimised on the transfer of assets to a new trustee provided that the deed of change of trustee is drafted correctly. Importantly, trusts allow a half way house whereby parents can cede day to day control of the business to their children by giving them control of the trustee, but retain overall control by remaining appointors of the trust. This can allow parents to gradually cede control over time as the children gain more maturity and experience.
- 3.3 In a situation where you have unrelated parties who carry on a business together or adult children with differing goals, business succession planning generally involves some sort of buy-sell agreement between the parties. Such an agreement would essentially outline what happens to the business upon the death or severe incapacity of one of the business owners. Failure to have an appropriate buy-sell agreement in place could lead to acrimonious disputes later on between surviving business owners and the deceased's spouse or the business being paralysed (with the resultant loss of goodwill) during the time it takes to broker an appropriate arrangement in relation to ownership of the deceased owner's interest in the business.
- 3.4 A good buy-sell agreement would generally outline the terms on which a business owner's interest in the business will be disposed of to the surviving business partners in the event of death or severe incapacity and the way that such a purchase will be funded. There are different models in relation to how a buy-sell agreement is structured both in relation to the way the agreement is drafted and how it is funded. Some models involve cross-ownership, whilst others involve insurance policies held by a trust.
- 3.5 It is critical to structure a buy-sell agreement correctly to ensure that adverse CGT liabilities are not triggered and appropriate CGT consequences arise. Generally, to minimise tax and to allow business owners to enter and exit a business easily we recommend that a buy-sell agreement be:
 - (a) drafted with put and call options that are triggered by a business owner's death or severe incapacity; and
 - (b) a self insurance model of funding be adopted.
- 3.6 Using put and call options rather than a conditional contract defers the CGT liability on the disposal of an outgoing business owner's disposal of their business interest until a later time when an option under the buy-sell agreement is exercised and a contract of sale entered into.
- 3.7 Under the self insurance model each business owner takes out their own insurance policy to cover death and disability – i.e. each business owner is the beneficial owner of their own insurance policy. If a business owner subsequently dies or becomes severely incapacitated then the insurance proceeds are paid directly to the business owner or their beneficiaries. The direct receipt of insurance proceeds is a major benefit of the self insurance model and contrasts with other funding models such as cross-

³⁰ Further discussion in relation to buy-sell arrangements can be found in MBP Legal's publication "Planning for the unplanned using insurance funded buy-sell agreements" which can be found at our website: www.mbplegal.com.au {00113834}



ownership or a trust where the surviving business owners may control how the insurance proceeds are dealt with. Provided the recipient of the insurance proceeds is:

- (a) the beneficial owner of the policy (in the case of life insurance); or
- (b) the incapacitated business owner or a relative³¹ of the incapacitated business owner (in the case of accident/trauma insurance),

then no capital gains tax will be payable on the receipt of the proceeds.³²

3.8 A good buy-sell agreement will typically provide that the surviving business owners will pay a purchase price for the business interest equal to the difference between its market value and the insurance proceeds received. Where adequate insurance is taken out, the insurance proceeds received will effectively constitute the purchase price paid for the outgoing business owner's business interest. Because in reality the surviving business owners will not have paid this purchase price, the CGT market value deeming rules will deem:

- (a) the outgoing business owner to have disposed of their business interest for market value; and
- (b) importantly that the surviving business owners will have acquired the business interest for market value – this gives them a market value cost base.

Market value is determined at the time the option under the buy-sell agreement is exercised and the sales contract entered into.

3.9 Any capital gain made on the sale of an outgoing business owner's business interest may be reduced by the 50% CGT discount and the small business CGT concessions where certain conditions are met.

3.10 The 50% CGT discount may be claimed where the outgoing business owner owned the business interest for more than 12 months prior to its disposal. It is noted that a trustee of a deceased estate will be considered to have acquired the business interest at the time the deceased acquired the interest, for the purposes of determining whether this 12 month rule is met.³³

3.11 Significantly, the trustee of a deceased estate or a beneficiary who receives a business interest from a deceased estate may claim the benefit of small business CGT concessions where:

- (a) the deceased individual would have been able to claim the small business CGT concessions if the disposal occurred immediately before their death; and
- (b) the disposal of the business interest occurs within 2 years of the deceased's death.³⁴

3.12 The benefits of having a properly structured buy-sell agreement is illustrated in the following example.

Example 7

Julia, Kevin and Wayne carry on a travel agency business as a partnership of individuals in equal shares. Whilst Julia has her feet firmly planted on the ground, Kevin is into extreme XXX sports and Wayne likes rock fishing. Keen to ensure that the running of the business is not affected by any misfortune that may befall any of the partners and that each of their partnership interests in the business is disposed of for a fair price for the benefit of their loved ones, Julia, Kevin and Wayne enter into a buy-sell agreement drafted by MBP Legal. Broadly, the agreement contains put and call options which have the effect that on the death or severe incapacity of a partner, their partnership interest will be sold to the other remaining partners.

The partners then obtain a market valuation of the business which equates to roughly \$1.5M. Each partner then self-insures by taking out their own life and accident insurance up to the value of \$500,000 so as to be able to cover the buy out of their partnership interest should misfortune strike.

³¹ "Relative" is a defined term and includes spouse, parent, grandparent, brother, sister, uncle, aunt, nephew, niece or lineal descendant: ITAA97 s995-1(1).

³² ITAA97 ss118-37(1)(b) and item 3, 118-300(1).

³³ ITAA97 item 1, s115-30.

³⁴ ITAA97 s152-80.

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In a twist of fate, Julia gets hit by a bus. At this time the market value of the business is \$1.6M. The buy-sell agreement would operate with the following consequences:

Julia's deceased estate would receive life insurance proceeds of \$500,000 tax-free. Julia's loved ones received these proceeds directly and there is no bitter negotiations between themselves and Kevin and Wayne in relation to the disposal of the partnership interest.

On receipt of the life insurance proceeds, the option under the buy-sell agreement would be triggered such that Julia's partnership interest would be disposed of to Kevin and Wayne in equal shares. Neither Kevin nor Wayne have paid any consideration for this transfer.

The sale of Julia's partnership interest triggers a capital gain for the trustee of Julia's deceased estate equal to the market value of the interest at the time of the sale less her cost base in the partnership interest.³⁵ Assuming Julia had a cost base in her partnership interest of nil – the partners having built the business up from scratch, then this produces a taxable capital gain of \$533,333. The trustee of Julia's deceased estate, however, can use the 50% CGT discount and the small business CGT concessions to reduce this capital gain.

Kevin and Wayne are each deemed to have acquired a 1/6th partnership share in the business from Julia for a market value cost base of \$266,667.

4

Superannuation death benefits

Importance of planning what occurs upon a member's death – BDBNs

- 4.1 As noted above superannuation does not automatically form part of a person's deceased estate and so may not be covered by a person's Will. What determines who benefits from a deceased's superannuation death benefit will be:
- (a) the trust deed of the superannuation fund;
 - (b) whether the deceased made a BDBN; and
 - (c) whether or not the pension received by the deceased is reversionary.³⁶
- 4.2 Under superannuation law, generally the only persons who can receive superannuation death benefits are:
- (a) the deceased member's dependants; or
 - (b) the deceased member's legal personal representative (e.g. the executor/trustee of their deceased estate).³⁷
- 4.3 A "dependant" includes a person's spouse,³⁸ child, a person who was financially dependent on the deceased at the date of their death and any person with whom the person has had an interdependency relationship at the date of their death.³⁹
- 4.4 As a general starting proposition, the trustee of the superannuation fund has an absolute discretion to determine who should be paid a deceased member's superannuation death benefit. The trustee makes this choice from the classes of persons outlined in paragraph 4.2 above. Where it is desired that a non-

³⁵ This market value may differ from the \$500,000 insurance proceeds received.

³⁶ A reversionary pension is pension arrangement under which a person is nominated to receive the pension upon the deceased member's death. That is, upon death the pension automatically reverts to the nominated beneficiary. Please note only a limited class of persons (referred to in paragraph 4.12) can be named as reversionary beneficiaries to a pension.

³⁷ Regulation 6.22 of the Superannuation Industry (Supervision) Regulations 1994 ("SIS Regs").

³⁸ This term includes same sex partners.

³⁹ Subsection 10(1) of the *Superannuation Industry (Supervision) Act 1993* ("SIS Act"). Broadly, persons are in an interdependency relationship where they have a close personal relationship, live together, one or each provides the other with financial support and one or each provides the other with domestic support and personal care: SIS Act s10A.

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dependant receive the superannuation death benefit, then the normal process is for the trustee to pay the death benefit to the deceased's legal personal representative who then distributes the death benefit in accordance with the deceased member's Will.

- 4.5 The trustee's absolute discretion may, however, be overridden where a deceased member has made a valid BDBN or the deceased member was in receipt of a reversionary pension. In such situations the trustee is compelled to follow the terms of the BDBN or the terms of the reversionary pension, except where it would otherwise be contrary to superannuation law (e.g. where a nominated beneficiary of a BDBN is not one of the persons referred to in paragraph 4.2 above).
- 4.6 Superannuation estate planning generally involves determining whether a member should make a BDBN or leave it to the discretion of the trustee. The taxation of superannuation death benefits can play a role in this choice.
- 4.7 A member of a superannuation fund can only make a BDBN if the trust deed for the fund allows for such nominations. Generally, the trust deed will prescribe the procedure and forms which need to be completed before the BDBN is valid. For retail superannuation funds there is also a set statutory procedure⁴⁰ that must be adhered to before a BDBN is valid. The requirements of this statutory procedure include that:
 - (a) the BDBN be in writing and witnessed by 2 persons over the age of 18 years who are not nominated as beneficiaries under the BDBN;
 - (b) the BDBN must clearly state the proportion of the total death benefit payable to each beneficiary and the total proportions must equal 100% of the death benefit; and
 - (c) the BDBN must be confirmed every 3 years for it to continue to be valid.
- 4.8 BDBNs made in relation to self managed superannuation funds ("SMSFs") are not governed by this statutory procedure.⁴¹ Rather their validity will be governed solely by the terms of the SMSF trust deed and whether the beneficiaries nominated fall within the class of persons referred to in paragraph 4.2 above. Importantly, it is possible for a BDBN to be made in respect of a SMSF which lasts indefinitely – as opposed to 3 years for a retail superannuation fund.
- 4.9 Whether it is a good idea to make an indefinite BDBN involves weighing up the consequences of a BDBN potentially lapsing because it has not been confirmed within the relevant time period, and the potential for changes to occur in a member's personal circumstances which make their BDBN not appropriate anymore. Good superannuation trust deeds (such as the MBP Legal trust deed) would contain clauses which automatically invalidate a BDBN should a member's personal circumstances change such as where they have another child or they suffer a permanent relationship breakdown. In any event, good estate planning requires monitoring and clients should be advised to revoke and replace a BDBN when their personal circumstances alter.
- 4.10 The following example outlines the facts of *Katz v Grossman* (2005) NSWSC 934 which illustrates how important the making of a BDBN can be.

Example 8

Ervin and Evelin Katz, a husband and wife, had their own SMSF. When Evelin died, Ervin appointed his daughter Linda to be the additional trustee of the SMSF so that it could retain its status as a SMSF. Linda became a member of the SMSF approximately 4 years later.

Prior to Ervin's death, he executed a non-binding death benefit nomination whereby he indicated that he wished his superannuation death benefits to be shared equally

⁴⁰ SIS Reg 6.17A.

⁴¹ SMSFD 2008/3.
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between his children, Linda and Daniel. Ervin's Will also split his non-superannuation assets 50/50 between the children.

Ervin died in September 2003 and in December 2003, Linda as the remaining trustee appointed her husband Paul as an additional trustee. The SMSF trust deed provided that the trustee of Ervin's deceased estate could appoint an additional trustee, however, this was not functioning at the time as probate was not obtained until August 2004.

As Ervin's nomination was not a BDBN, the trustees of the SMSF (being Linda and her husband) resolved to pay the whole of Ervin's \$1M death benefit to Linda. Daniel challenged this trustee resolution in the Supreme Court and lost since Ervin's nomination was non-binding.

Accordingly, Linda was able to totally usurp her father's wishes.

How could this result have been avoided?

Ervin could have executed a BDBN in favour of Daniel and Linda in equal shares.

Ervin's Will could also have been drafted to include an equalisation clause, such that Linda's share of non-superannuation assets would be reduced and Daniel's share increased to reflect the fact that Linda received all the superannuation death benefits. The effectiveness of this clause depends on the value of non-superannuation assets in the deceased estate as opposed to superannuation assets.

Ervin may also have considered structuring the trusteeship of the SMSF with more care so that on death his wishes would be respected. For instance, instead of appointing Linda as co-trustee, Ervin could have appointed a corporate trustee for the SMSF of which he owned 100% of the shares. In his Will, he could have given the shares in the corporate trustee equally to Linda and Daniel and made the executor of his Will an independent suit (such as a solicitor or accountant). In such a situation, neither child would have control of the trustee of the SMSF and it would be likely that the suit would be appointed director of the corporate trustee and ensure that Ervin's wishes are carried out.

- 4.11 Whilst many pro-forma BDBN nomination forms merely provide for outright lump sum pay outs of a deceased's death benefits, it is important to be aware that BDBNs are not limited to lump sum payments. The drafting of a BDBN can be complex and can cater for alternative contingencies provided the rules outlined in paragraphs 4.2, 4.7 and 4.8 above and the next paragraph are adhered to.
- 4.12 A BDBN can provide for the payment of death benefit pensions from a superannuation fund. Where a death benefit pension is contemplated then the following rules in superannuation law which govern who can receive the pension must be adhered to:
- (a) a death benefit pension can only be paid to a dependant of the deceased member (as described in paragraph 4.2 above);
 - (b) if the dependant is a child of the deceased member, then the child can only continue to receive the death benefit pension whilst:
 - (1) they are under the age of 18 years;
 - (2) they are between the ages of 18 and 25 years of age and were financially dependant on the member at the date of their death; or
 - (3) they have a disability of the kind described in section 8(1) of the *Disability Services Act 1986 (Cth)*; and
 - (c) a death benefit pension received by a child must be commuted and the balance paid out to the child on the day they reach 25 years of age (the exception to this is where the child has a disability as described in paragraph (b) above).⁴² The pay out of the balance of superannuation to the child at this time is tax free.⁴³

Tax planning surrounding the distribution of superannuation death benefits

- 4.13 The taxation of superannuation death benefits is summarised in the following tables:

⁴² SIS Reg 6.21.

⁴³ ITAA97 s303-5.
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Taxation of Lump Sum Death Benefit Payments

Type of recipient	Tax-free component	Taxable component	
		Taxed element	Untaxed element ⁴⁴
Death Benefit Dependant	Tax free	Tax free	Tax free
Non-Death Benefit Dependant	Tax free	16.5% tax	31.5% tax

- 4.14 A “death benefit dependant” for tax purposes differs from a “dependant” for superannuation law purposes (as described in paragraph 4.2 above). A “death benefit dependant” means:
- (a) the deceased member’s spouse or former spouse;⁴⁵
 - (b) the deceased member’s child provided that they are aged less than 18 years at the time of the deceased’s death;
 - (c) a person who was in an interdependency relationship with the deceased member just before their death; and
 - (d) a person who was financially dependant on the deceased member just before they died.⁴⁶

Taxation of Death Benefit Pensions

Age of deceased at date of death	Age of recipient at date of pension payment	Tax-free component	Taxable component	
			Taxed element	Untaxed element
Under 60	Under 60	Tax free	MTR ⁴⁷ less 15% offset	MTR
Under 60	60 or above	Tax free	Tax free	MTR less 10% offset
60 or above	Any age	Tax free	Tax free	MTR less 10% offset

- 4.15 The tax planning surrounding the distribution of death benefits revolves around trying to ensure that death benefits are either paid as a lump sum to death benefit dependants or as an income stream to recipients who are over the age of 60 years – in both cases producing a tax free result. Where it is not possible to pay a death benefit to such persons, then much of the tax planning revolves around trying to increase the tax-free component of a member’s accumulated superannuation benefits via a re-contribution strategy or trying to rely on the anti-detriment deduction to effectively increase the cash payment out to a non-tax preferred person.
- 4.16 There are a myriad strategies which may be employed to minimise the tax on the pay out of a deceased’s superannuation death benefits. What is the right strategy depends on a member’s personal circumstances and the tax components of their accumulated superannuation benefits. In this paper we will explore two strategies which may be employed in dealing with a member’s superannuation death benefits.

⁴⁴ Generally the taxable component of a death benefit paid from a SMSF will only include taxed elements (i.e. elements upon which the fund has been subject to tax). Untaxed elements are outlined in Subdiv 307-E of the ITAA97 and include, inter alia, life insurance proceeds where the life policy is held by the SMSF, amounts from public sector funds or where the fund claimed deductions for insurance premiums. The discussion in this paper assumes that there is no untaxed element in a person’s superannuation benefits.

⁴⁵ This includes same sex partners.

⁴⁶ [TAA97 s302-195.

⁴⁷ Meaning marginal tax rate.

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Account-based pension – Benefits of keeping super within superannuation

- 4.17 There is a benefit in keeping superannuation benefits within the superannuation environment as opposed to paying those benefits out as a lump sum on death. These benefits include the fact that income derived by the superannuation fund which funds a pension (including a death benefit pension) is not taxable to the fund. Lower marginal tax rates (and even a nil tax rate) can be generated by using a death benefit pension. The following example illustrates the benefits of retaining superannuation within a fund, and paying a beneficiary a death benefit pension.

Example 9

Marjorie is a wealthy independent retiree with a spendthrift husband, Paul. Whilst they are in a loving relationship, she is worried that if she gifts her accumulated superannuation to Paul (which stands in excess of \$4M) he will dissipate it quickly. She is also concerned to ensure that Paul will be provided for after she dies, knowing that he has no concept of a budget and without her wealth would otherwise be reliant on the old age pension. At the back of Marjorie's mind is the fact that she does not want Paul to make a family provision claim against other assets of her deceased estate which she wants to go to her adult children.

Both Marjorie and Paul are over the age of 60 years.

Marjorie seeks advice from her local solicitor who promptly drafts a Will which provides that the trustees of her deceased estate will hold one portion of her residuary estate on trust to pay Paul income during his lifetime, with the capital balance to be paid on his death to Marjorie and Paul's children in equal shares.

Two years later Marjorie comes to MBP Legal to review her estate planning.

There are two flaws in the Will drafted by the local solicitor. Firstly, as stated above superannuation does not automatically form part of Marjorie's deceased estate. Whether the superannuation flows to the trustees of her deceased estate depends on whether Marjorie made a BDBN to such effect or whether the trustee of her superannuation fund chooses to exercise his discretion to pay the death benefits to her deceased estate.

Secondly, the tax consequences of this testamentary trust are unfavourable when compared with the payment of a death benefit pension to Paul. This is because Paul will be liable to pay tax at his marginal tax rate on any income distributed to him from the trust. This compares with a death benefit pension which would not be assessable to Paul since he is over the age of 60 years.

Accordingly, the more tax effective approach would be for Marjorie to execute a BDBN under which she directed the trustee of her superannuation fund to pay an account-based pension to Paul.

One non-tax issue which arises out of implementing this account based pension strategy is the fact that Marjorie does not want Paul to have access to pension capital. The payment of an account based pension may involve payment of part of the pension capital each year due to the operation of the percentage factors which govern the minimum amounts which need to be paid from the account based pension. However, the erosion of pension capital under an account-based pension may be similar to what would occur under the testamentary trust alternative where the trust makes a loss and the trustees have to dip into capital to make a distribution to Paul for his living expenses. Assuming Marjorie is happy to live with the possibility that some pension capital is paid out under the account-based pension and her main fear is Paul being able to get his hands on the whole of the pension capital at one go, then the main issue would be controlling Paul's ability to commute the pension.

Whilst the SIS Regulations outline minimum standards which must be satisfied before a pension is classed as an account based pension, it does not prescribe all the conditions that may attach to such a pension. Accordingly, it is possible to draft the pension payable to Paul as a pension which cannot be commuted in his lifetime except in a situation where he becomes seriously ill or needs to move into assisted care. To prevent Paul from effectively drawing out large lump sums as pension amounts, the pension would also be drafted such that subject to the pay out of minimum pension amounts each year, the amount Paul can draw as a pension in each year is capped.

The only issue then is who receives any remaining pension capital upon Paul's death – such pension capital would be considered Paul's superannuation death benefits. As



Paul is the relevant member – it is his dependants for superannuation purposes and legal personal representative who are the class of persons who can receive the pension capital on his death. Paul and Marjorie's children are dependants of Paul's for superannuation purposes. The main issue is how to ensure that on Paul's death the pension capital goes to these children in equal shares.

The best method would be to have Paul execute a mutual will contract whereby he agrees to make an irrevocable BDBN after Marjorie's death (which, as the fund is a SMSF, can last indefinitely) under which pension capital would be paid in equal shares to the children.

However, what if Paul is uncooperative or Marjorie feels uncomfortable asking Paul to execute the BDBN?

One alternative may be to explicitly state in the trust deed the terms of the pension such that on Paul's death, the pension capital is to be paid to his adult children on his death in equal shares and to expressly forbid the making of a BDBN by a pension member such as Paul. This alternative has not been judicially tested but arguably the inclusion of such trust provisions prior to Paul becoming a member of the fund is possible since it does not involve disadvantaging an existing member of the fund. Additionally, the statutory provisions in relation to BDBNs do not prevent such provisions.

To further forestall the possibility of Paul seeking to pay the pension capital, Marjorie could move to have one of the children installed as co-trustee of the SMSF. That co-trustee could then ensure that upon Paul's death the pension capital is paid out as per Marjorie's wishes. This assumes that this child will follow Marjorie's wishes. If there is a concern that they will not then consideration should be given to making all the children members and hence trustees of the SMSF – this could involve a small superannuation contribution for each child.

It is noted that the strategy of paying the death benefits to the adult children has the result that the children would be taxed on the receipt of the benefits at 16.5%. But in these circumstances where there are no other beneficiaries such a taxing result is acceptable. The use of a non-commutable superannuation pension is much more acceptable than purchasing a retail pension for Paul from a life office, since in that latter circumstance pension capital will generally be lost to the life office on Paul's death.

- 4.18 In the above example a superior tax result was achieved because Paul is aged over 60 years and hence received the death benefit pension tax free. A similar tax free result may also be achieved where the recipient is under the age of 60 years but the deceased member is over the age of 60 years.
- 4.19 Where a pension beneficiary is under the age of 60 years and the deceased member dies before they reach the age of 60 years, the pension beneficiary will be taxed on their receipt of the pension at their marginal tax rates less a 15% tax offset. The presence of this offset makes it attractive to set up a death benefit pension for a younger person (such as a child) since it contrasts favourably with the other alternative of receiving income from a testamentary trust which is taxed at marginal rates without the tax offset.
- 4.20 The main draw back of paying a child an account based pension out of superannuation death benefits is the fact that the pension must be commuted and paid out to the child beneficiary when they turn 25 years of age. Many parents are concerned that 25 years may be too young an age to deal with the receipt of a large sum. Generally, the solution to this concern is for a parent to establish a superannuation proceeds trust in their Will.

Superannuation Proceeds Trust

- 4.21 As discussed at an earlier stage in this paper, a superannuation proceeds trust is a special testamentary trust created under a person's Will which contains a requirement that the child beneficiary for whose benefit the superannuation death benefits were transferred must eventually be entitled to receive the capital of the trust representing the transferred death benefits.
- 4.22 In order to prevent the child beneficiary from being absolutely entitled to these benefits and ending the trust prematurely when they turn 18 years under the rule in *Saunders v Vautier*, the typical way that a superannuation proceeds trust is structured is to have the surviving spouse as a discretionary income



beneficiary in the trust. The surviving spouse would be given control of the trust, by being appointed the trustee and appointor of the trust and in this way the children can only obtain control of the trust at such later time when the surviving parent determines that they are mature enough to control their own affairs.

- 4.23 The beneficiaries of a superannuation proceeds trust would generally be confined to persons who fall within the definition of a death benefit dependant – the surviving spouse and the children provided that they are under the age of 18 years at the time of the deceased member's death fall within this definition. By restricting the beneficiaries to this class of persons it ensures that the trustee of the superannuation proceeds trust is not taxed on the receipt of the death benefits. If the superannuation proceeds trust includes a person who is not a death benefits dependant, then the trustee will generally be taxed on the receipt of the death benefits at the rate of 16.5%. Sometimes where adult children are involved there may still be a benefit in establishing a superannuation proceeds trust despite this tax if the adult children face insolvency risks.
- 4.24 The tax treatment for a beneficiary of a superannuation proceeds trust is not as favourable as the payment of a death benefits pension from superannuation. As discussed, a child beneficiary would be taxed as an adult at marginal tax rates on any income distributions they receive from the trust, since income from a correctly established superannuation proceeds trust is excepted from the penalty tax rates in Division 6AA of the ITAA36. If such a child beneficiary received a death benefit pension instead they would be entitled to claim a 15% tax offset on pension income received. This, however, is the price for a parent retaining some control of the superannuation death benefits.
- 4.25 The use of a superannuation proceeds trust will also preserve capital more readily than a death benefits pension. This is because the trustee of the superannuation proceeds trust can determine when capital is paid out to a child beneficiary. Where a death benefits pension strategy is employed, then the only type of pension that can be paid from a SMSF is an account based pension. As discussed, above the percentage factors which outline the minimum pension payments which must be made each year, are set with the intention that income and capital are paid to a beneficiary each year.
- 4.26 The following example shows how a superannuation proceeds trust may be utilised in a Will to provide for young children.

Example 10

Henry and June have two children Jack and Michelle who are aged 2 and 3. Henry and June are both in their early 40s. June is a medical specialist and is wary of holding assets in her own name because of litigation risks.

Henry has a successful importing business and has managed to amass a substantial amount in his superannuation of around \$3M. The net income before tax generated by the fund on these assets annually is around \$210,000.

The couple also own personally around \$1.5M in non-superannuation assets. These assets represent a property portfolio and shares held through a discretionary investment trust.

The importing business is carried on through another discretionary trading trust.

The beneficiaries of the discretionary investment trust and discretionary trading trust are drafted widely to include all entities related to Henry and June.

How should Henry's estate plan be structured?

Since the importing business and the property and share portfolios are not held personally by Henry, the main estate planning issue revolves around how control of these trusts is transferred on Henry's death. For asset protection reasons it is not desired that June solely control either of these trusts and accordingly, Stuart, the couple's loyal accountant, is nominated as co-trustee and appointor of the trusts should Henry die. To keep Stuart honest, both he and his related entities are expressly excluded as beneficiaries of the trusts.

In relation to Henry's accumulated superannuation there are a number of choices:

- (a) *lump sum payments;*



- (b) death benefit pensions; or
- (c) establishing a superannuation proceeds trust.

Henry would like to gift his superannuation equally between June and the children.

With respect to the children due to their age the only real options are either to pay death benefit pensions or to establish a superannuation proceeds trust. The thought of having the children receiving a lump sum payment of around \$1M each when they turn 25 years is unappealing and so Henry establishes a superannuation proceeds trust in his Will with the following terms:

- (a) the only beneficiaries in the trust are the children and June;
- (b) the children are discretionary income and capital beneficiaries;
- (c) June is only a discretionary income beneficiary;
- (d) control of the trust (i.e. appointor and trustee role) is shared between June and Stuart;
- (e) Stuart and his related entities are expressly excluded from being beneficiaries of the trust.

Since the beneficiaries of the superannuation proceeds trust are confined to Henry's death benefit dependants, no tax is payable by the trustee of that trust when they receive the death benefit payment from the superannuation fund.

The tax profile on the income generated by this trust is favourable since income from the superannuation proceeds trust is excepted from Division 6AA's penalty tax rates. Assuming that \$140,000 is derived annually on assets of \$2M then this income can be shared equally between the two children. This produces a tax bill of \$32,100⁴⁸ which is less than what would occur Division 6AA if applied with the tax in that latter situation being \$65,100.⁴⁹

It is noted, however, that this tax result is less favourable than the receipt of a death benefit pension where a 15% tax offset would further reduce the tax bill to \$27,600.⁵⁰

With respect to June's \$1M share of Henry's death benefits, the concern would be making a lump sum payment to her where it would be at risk to creditors. If asset protection is the main concern then the \$1M share may be paid to the discretionary investment trust. June can then benefit from the death benefit on a discretionary basis. However, this strategy would trigger a \$165,000 tax bill for the trustee of that trust when they receive the death benefit. A better strategy may be to keep the amount in superannuation and pay June a death benefits pension on which she may claim a 15% tax offset.⁵¹ Importantly a person's interest in a superannuation fund, no matter its size, does not form part of property which may be distributed to creditors on bankruptcy.

Henry would execute a BDBN directing that the trustee of his SMSF pay his death benefits to the trustee of his Will so that his Will directions can be followed.

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⁴⁸ i.e. $2 * (1.5% * 70,000 + 4,200 + 30% * (70,000 - 34,000))$.

⁴⁹ i.e. $46.5% * 140,000$.

⁵⁰ i.e. $2 * (1.5% * 70,000 + (4,200 + 30% * (70,000 - 34,000)) * 85%)$.

⁵¹ This assumes that Henry dies before 60 years and June is younger than 60 years when she receives the pension payments.
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