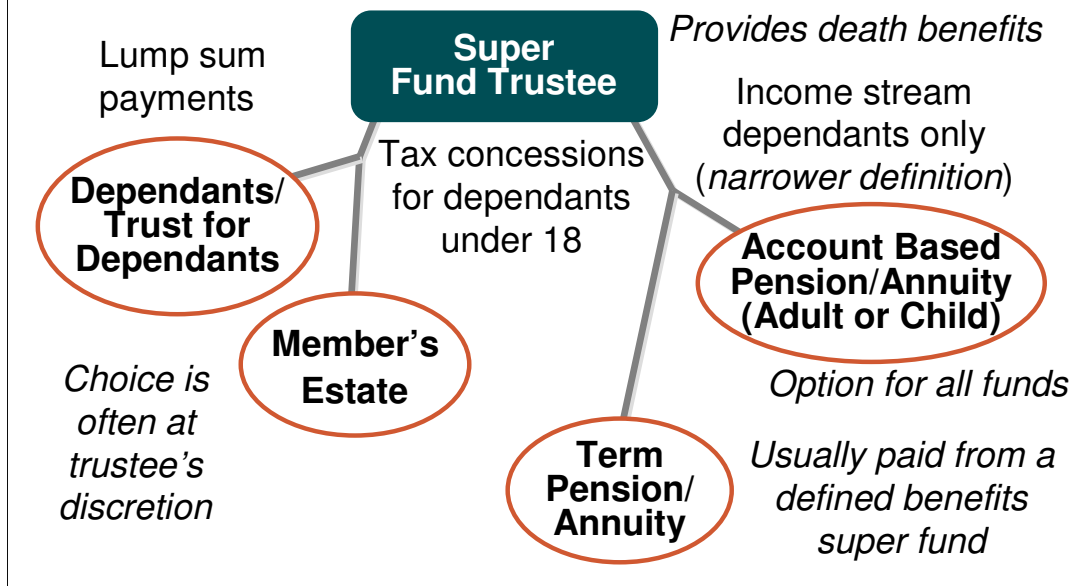


Superannuation Death Benefits – Payment Choices



Paying Superannuation Death Benefits – All Australian Funds

As a consequence of the sole purpose test (see section 62 of the *Superannuation Industry Supervision Act 1993* (the "SIS Act") and the accompanying *Superannuation Industry Supervision Regulations 1994* (the "SIS Regs"), the choices as to payment of death benefits by the trustee of an Australian superannuation fund are:

1. Lump Sum – Member's Estate

A lump sum of all or part of the death benefits can be paid to the estate of the deceased. Where the deceased has no surviving dependants (or wishes to ensure that one person receives the income benefit and another person [or charity] receives the capital benefit from the superannuation monies), this is the only option open to the trustee of a superannuation fund.

2. Lump sum – Dependants

A lump sum can be paid directly to (or held on trust for) one or more "lump sum" dependants of the deceased, eg a surviving spouse, a child of any age or another person who was financially dependant on, or interdependent with, the deceased at the date of deceased's death).

3. Pension or Annuity – Income Stream Dependents

In addition to the rules relating to superannuation income streams generally, an income stream commenced after the death of a fund member is only be possible if the person to receive the income stream was an "income stream" dependant of the deceased. The meaning of "child" is narrower under this definition, ie it only includes children under 18 years of age, financially dependant children under 25 and children of any age that have a significant disability. Unless the child has a significant disability, any child death benefits pension that is established will need to be cashed in when the child attains 25 years.

Dependants – Super Death Benefits

3 Separate Definitions

- * r6.21(2A) – “**Income stream**”
- * s10(1) – “**Lump sum**”
- * s302-195 – “**Death benefits**”
(ie no death benefits tax)

If there are *no* lump sum dependants, death benefits must be paid to the member’s estate

Definition of “child” varies

All 3 definitions include spouses/ domestic partners & (for people other than children) financial dependants & interdependants

All 3 definitions can *sometimes* include parents, grandchildren, close friends – see **Malek, Faull, Noel & Cook**

Definition of Dependants

There are 3 critical definitions narrowing or extending the normal “non-superannuation” and “non-tax” meaning of the term “dependants” when identifying dependants for superannuation death benefit purposes. The 3 definitions are:

- The relatively narrow definition for **income stream** purposes (governing who can commence an income stream, eg a pension or annuity, out of superannuation death benefits paid in respect of a fund member who died in either investment or benefits phase, as well as the rules for a reversionary pensioner or annuitant of a retirement or transition to retirement income stream) – see subregulation 6.21(2A) of the *SIS Regs*;
- The general (relatively) wide definition for **lump sum** purposes (determining who can receive a lump sum payment of death benefits) – see *subsection 10(1) of the SIS Act*; and
- The third (generally narrower) definition for income tax purposes (determining who is exempt from income tax on the otherwise taxable component of lump sum **death benefits**) – see section 302-195 of the *ITAA 1997* (note that ex-spouses fall within this definition).

The key differences between the 3 definitions are in the coverage of children.

Interpretation of Ordinary Meaning of “Dependant”

The ATO has tended to take a narrow view of who qualifies under the ordinary meaning of a “dependant”. Successful cases have usually only required proof of a degree of dependence, eg payment of board to a mother (*Faull v Superannuation Complaints Tribunal [1999] NSWSC 1137*), financial support of a close friend (*Noel v Cook [2004] FCA 479*) and parent/child interdependency (ID 2005/143).

Children as Dependants

Definition	r6.21 (2A)	S10(1)
	Income Stream	Lump Sum
Category of Child		
Under 18	Yes	Yes
18-25 & financially dependent	Yes	Yes
25+ & financially dependent	No	Yes
Interdependency relationship	No	Yes
Any age – Disability Services definition	Yes	Yes
None of the above	No	Yes

Children as Dependants

Income Stream – this is (usually) the narrowest of the 3 definitions. To be eligible to commence an income stream, eg a pension or annuity, funded by superannuation death benefits (or to continue an income stream on after the fund member dies), the child must:

- Be between 18 and 25 years of age and financially dependent at the date of death or less than 18 years of age (compulsory cashing rules apply to the income stream at age 25); or
- Have a “disability” as defined in subsection 8(1) of the *Disability Services Act 1986* – the compulsory cashing rules don’t apply for children with a “disability”.

It is possible for a child with a significant disability to be an “income stream” dependant, but not a “death benefits” dependant for lump sum income tax purposes.

Lump Sum – any child (including a stepchild) of the deceased fund member is a dependant for lump sum death benefits purposes in the superannuation legislation.

Death Benefits – when a lump sum death benefit is paid to a child, the benefit is subject to income tax on the taxable component of the lump sum death benefit if the child was an adult at the time the fund member died and was not financially dependent on, or interdependent with, the deceased fund member. (Former spouses are automatically “death benefits” dependants, but may not meet the other 2 definitions.)

“Child” and “Stepchild”

The definition of “child” includes natural and adopted children, as well as a stepchild if the parent through whom the step relationship is created is still living when the step parent’s death benefits are being paid.

Children & Death Benefits Tax

Death Benefits Tax on Lump Sum Payments

Category of Child	Taxable Component
Under 18	Not Taxed
18-25 & financially dependent	Not Taxed
25+ & financially dependent	Not Taxed
Any age – interdependency relationship	Not Taxed
None of the above	Taxed

Definition of Death Benefits Dependant – ITAA 1997

Subsection 302-195(1) of ITAA 1997

“A death benefits dependant, of a person who has died, is:

- (a) the deceased person's spouse or former spouse; or
- (b) the deceased person's child, aged less than 18 years of age; or
- (c) any other person with whom the deceased person had an interdependency relationship under section 302-200 just before he or she died; or
- (d) any other person who was a dependant of the deceased person just before he or she died.

Note: Subsection 302-195(2) also includes in the above definition any person receiving death benefits paid in consequence of a member of the armed forces or a police officer who died in the line of duty.”

Definition of Interdependency Relationship – ITAA 1997

Subsection 302-200(1) of the ITAA 1997

“Two persons (whether or not related by family) have an interdependency relationship under this section if:

- (a) they have a close personal relationship; and
- (b) they live together; and
- (c) one or each of them provides the other with financial support; and
- (d) one or each of them provides the other with domestic support and personal care.”

Note: Subsection 302-200(2) also includes in the above definition persons who have a close personal relationship and would have satisfied the remaining paragraphs above but for either or both of them suffering from a physical, intellectual or psychiatric disability.

Child (Death Benefits) Pension

Not available from all super funds & in all circumstances

Super
Fund Trustee

Pension (or annuity) payments made to dependant's guardian until dependant turns 18 years

Child Death
Benefits Pension
or Annuity

Usually, but not always a child of the deceased under 18

Deceased
Fund Member's
"Income Stream"
Dependant

Balance of pension account has to be paid to child dependant at age 25 (unless the child has a "disability")

Child Death Benefits Pensions – Eligibility

When a member of an Australian superannuation fund dies, most (but not all) trustees will permit the payment of a pension (or an annuity) to an "income stream" dependant (as defined by r6.21(2A) of the *SIS Regs*). Included in the class of income stream dependants are a:

- Child of the deceased under 18 years;
- Stepchild of the deceased under 18 years; and
- (In some circumstances) grandchild of the deceased.

Limitations of Child Death Benefits Pensions

- A non-conditional binding death benefit nomination by the deceased may prevent commencing a child death benefits pension.
- Unlike a testamentary trust, the control of the capital funding the child death benefits pension cannot remain with the child's surviving parent. The child death benefits pension income must be paid directly to the child once the child attains 18 years. The balance of the capital funding the child death benefits pension then must be paid to the child on demand or by the time the child is 25 years of age (unless the child has a "disability" – see the **Vulnerable Beneficiaries Pocket Summary**).
- Most minor grandchildren are not eligible to receive child death benefits pensions from their grandparent's superannuation death benefits because any financial support they might have benefited from during their late grandparent's lifetime, eg payment of school fees, is usually seen as financially benefiting the child's parent or parents (who would otherwise have received), rather than the child. Where ongoing financial support (eg an interest free loan to buy a house) is being provided to an adult grandchild, the grandchild may be eligible.

Income Tax – Child Pensions & Annuities (1)

2 income tax rates from TAXED source (assuming no other income)

- | | |
|--|---|
| 1. Nil | 1. Either former or current recipient at least 60 |
| 2. 15% tax offset – 1 st \$40,000 (ex Medicare Levy and low income tax offset) tax free | 2. Neither former or current recipient 60 |

Taxation of Superannuation Pensions and Annuities – Taxed Source

Pensions and annuities (whether funded out of income or capital) are usually taxed at the standard income tax rates applicable to superannuation income streams. If received by a child who is less than 18 years of age, section 102AE of *ITAA 1936* “excepts” the child from the penalty tax rules that apply to most forms of non-personal exertion income received by minors.

15% Income Tax Offset

A 15% income tax offset is available for pensions and annuities paid out of taxed source death benefits to pensioners who are currently under 60 years of age and thus not eligible to receive tax free superannuation income stream income (unless the deceased pensioner or annuitant died in benefits phase and was at least 60 years of age). If the recipients were minors at commencement of the pension or annuity, the first \$40,000 of income each year is income tax free (although still subject to Medicare Levy and possibly still qualifying for the low income Tax offset).

Commuting Child Death Benefits Income Streams

Initially, any power to commute a child death benefits income stream is held by the trustees, but in practice is very difficult to exercise while the recipient still has not attained 18 years. Once 18, the child (not the parent) holds the power to commute and compulsory cashing rules usually apply at age 25. Loans from the trustee to the child or a relative are prohibited.

Income Tax – Child Pensions & Annuities (2)

2 income tax rates from life insurance proceeds or other **UNTAXED** source (*assuming no other income*)

- | | |
|---|---|
| 1. 10% tax offset – 1 st \$20,000 (ex Medicare Levy & low income offset) tax free | 1. Either former or current recipient at least 60 |
| 2. Standard “adult” rates – 1 st \$6,000 tax free (ex Medicare Levy & low income offset) | 2. Neither former or current recipient 60 |

Taxation of Superannuation Pensions & Annuities – Untaxed Source

Pensions and annuities (whether funded out of income or capital) are usually taxed at the standard income tax rates applicable to superannuation income streams, regardless of the age of the recipient of the pension or annuity. If received by a child who is less than 18 years of age, section 102AE of the *ITAA 1936* “excepts” the child from the penalty tax rules that apply to most forms of non-personal exertion income received by minors.

10% Income Tax Offset (in Limited Circumstances)

No income tax offset applies to pensions and annuities paid from an untaxed source, eg the proceeds of death or total and permanent disability insurance policies owned by the trustee of a superannuation fund, unless the deceased died in benefits phase and was at least 60 years of age (in which case a 10% income tax offset applies). If the recipients were minors at commencement of the pension or annuity, the first \$40,000 of income each year is income tax free (although still subject to Medicare Levy and possibly still qualifying for the low income tax offset).

Commuting Child Death Benefits Income Streams

Initially, any power to commute a child death benefits income stream is held by the trustees, but in practice is very difficult to exercise while the recipient still has not attained 18 years. Once 18, the child (not the parent) holds the power to commute and compulsory cashing rules usually apply at age 25. Loans from the trustee to the child or a relative are prohibited.

Account Based Death Benefit Pensions

- * Paid **annually** (in one or more instalments)
- * **No standard maximum** percentage limit
- * Alternatives or modifications may be needed for **vulnerable** people (to avoid fraud & exploitation)
- * **Minimum percentages** – depending on age (*see notes*)
- * Compulsory cashing at 25 for most children

Minimum Annual Payments – All Account Based Pensions

A superannuation pension paid pursuant to the *SIS* regulations must be paid in at least one annual instalment.

The pension standards (*SIS* regulations 1.06 and 1.07A) that apply to account based pensions include the following minimum percentages of the opening balance for the financial year for annual pension payments (these payments can be made in one more instalments during each year): • Under 65: 4%. • 65-74: 5%. • 75-79: 6%. • 80-84: 7%. • 85-89: 9%. • 90-94: 11%. • 95+: 14%. (Those minimums were halved for the income years ended 30 June 2009 and 2010.)

No maximum ceiling applies to retirement or death benefits account based income streams that commenced (or were converted from other types of income streams) after 30 June 2007. The regulations do not prevent a maximum being set, hence the restricted account based pensions paid by SMSFs.

Definition of “Disability” for Superannuation Death Benefit Purposes

A child death benefits pension does not have to be cashed in at age 25 if the child meets the definition of “disability” in subsection 8(1) of the *Disability Services Act 1986*. The definition of a “disability” is that the disability:

- “(a) is attributable to an intellectual, psychiatric, sensory or physical impairment or a combination of such impairments;
- (b) is permanent or likely to be permanent; and
- (c) results in:
 - (i) a substantially reduced capacity of the person for communication, learning or mobility; and
 - (ii) the need for ongoing support services.”

Restricted Account Based Death Benefit Pensions

- * Used for vulnerable beneficiaries in SMSFs
- * Deed prevents pension commutation or payment above a **maximum** limit, eg 6% or age minimum
- * On the death of the pensioner, benefits are paid to pensioner's estate
- * Same annual payment & minimum percentage requirements as account based pension

Restricted Account Based Pensions

These restricted superannuation pensions are paid from an SMSF Deed that has key provisions that differ from a fund that only permits standard account based pensions. They have provisions common to standard account based reversionary pensions in that they still meet the pension standards in regulations 1.06 and 1.07A of the *SIS Regs*, eg as to:

- Frequency of payment; and
- Minimum annual payments based on the pensioner's age.

They include, however, a number of restrictions not found in standard account based pensions, eg:

- Maximum annual payment levels are set, eg the greater of 6% or the applicable age based minimum payment level;
- The pensions are not commutable into a lump sum or back into investment phase and cannot be transferred across to another self managed or other superannuation fund (special rules apply if the pensioner becomes bankrupt); and
- On the death of the pensioner, the balance of the pension account must be paid via the terms of the SMSF Deed to the pensioner's legal personal representative to be dealt with in the Will of the pensioner.

Often the executor of the Willmaker whose existing superannuation member account is to the fund the pension is given the power to choose between commencing the pension and paying the superannuation death benefits into the estate of the Willmaker and instead funding a special disability trust, an all needs protective trust or contributions into superannuation (and means tested exempt investment phase). Note: superannuation has a history of legislative change and the SMSF Deed needs to cover the possibility of a restricted account based pension not being available at some stage in the future.

Death Benefit RABPs for a Child with a “Disability”

- * Restricted account based pension (“RABP”) document itself
- * SMSF Deed – either blocking key amendments or ending RABP
- * Trustee constitution clauses – providing for 2nd director

Note: Bankruptcy poses particular problems

Documents Supporting a Restricted Account Based Pension

The portability rules in Division 6.5 of the *SIS Regs* that apply to pensions paid by from externally managed superannuation funds (“EMSFs”) make it difficult for the trustees of EMSFs to set up restrictions to protect these pensions, unless the trustee is paying a defined benefit income stream. In a self managed superannuation fund (“SMSF”), however, the portability rules do not apply (see reg 6.30 of the *SIS Regs*). The prospect of a restricted death benefits pension is generally a more realistic one, provided it is supported by appropriate documentation, eg:

- the restricted account based pension document;
- a suitable new, existing or upgraded SMSF Deed dealing with restricted account based pensions, preventing subsequent amendments to the Deed from overriding those pensions or overriding the BDBNs of the fund member and bringing the pension to an end if the member becomes a disqualified person or the fund cannot remain an SMSF; and
- special clauses in the constitution of the company trustee.

RABPs and Bankruptcy

The prospect of bankruptcy creates specific challenges for RABPs as a person who is a bankrupt is a “disqualified person” under subsection 17A(10) of the *SIS Act* and is unable to act as trustee or as a director of the director of the trustee company. Thus if the pensioner becomes bankrupt, the fund usually becomes a fund administered by APRA and thus a fund that is subject to the portability provisions in Division 6.5 of the *SIS Regs*.

For this reason, other protective structures such as a special disability trust or an all needs protective trust may be preferred – see the ***Vulnerable Beneficiaries Pocket Summary***.

Super Death Benefits Payment Options – Further Reading

**Australian Master Estate
Planning & Succession
Guide – Chapter 25**

**You Can't Take It
With You –
Chapter 15**

The latest version of this Pocket Summary is at
www.mooreslegal.com.au/services/epss/pocket-summaries

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Further Reading

- The 1st edition of the **Australian Master Estate Planning and Succession Guide** by Allan Swan is scheduled to be published by **CCH** in 2011.
- The 1st edition of **You Can't Take It With You** by Andrew Simpson was published by **Wrightbooks** in 2009.
- The 5th edition of **Tax Issues in Family Law Property Settlements** – The Difference Between Hacking and Carving by Peter Szabo was published by **MOORESLEGAL** in 2008.

About the Author of the Pocket Summaries – Allan Swan

In addition to his main role as a principal of the **MOORESLEGAL** estate planning team (working in the areas of **Asset Protection, Trusts, Superannuation, Tax and Estate Planning**) Allan is also the principal of **APTSTEP**, a provider of training and materials. Allan's current presentation topics are:

- Asset Protection Planning
- Blended Families (includes all pages of this Pocket Summary)
- Business Structures Overview
- Estate Planning – Key Cases and Rulings
- Estate Planning – Practical Case Studies for 2010
- Estate Planning – Tax and Strategic Issues (1-8)
- Funding Estate Planning
- Ruling from the Grave (all)
- SMSFs – Planning Issues (all)
- Superannuation Death Benefits (all)
- Superannuation Overview (all)
- Testamentary Trusts (1-4)
- Trusts – Income and Capital Distributions
- Trusts – The A-Z (all).

Contact Allan 03 9843 2153 for further information regarding on the content of the topics, the fees charged and to schedule a presentation, workshop or seminar.