

DEMYSTIFYING DEATH BENEFITS

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DEMYSTIFYING THE TAX TREATMENT OF DEATH BENEFITS PAID TO THE ESTATE

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The tax treatment of death benefits paid from an SMSF to a deceased member's estate can be complex. Tax law contains a 'look through' provision in respect of death benefits paid to an estate (ie, to a legal personal representative being the executor of a will or the administrator in the case of intestacy). This article examines the key criteria of this 'look through' provision and the resulting tax treatment.

'Look through' provision for death benefits paid to the estate

The relevant provisions that deal with death benefits paid to an estate are contained in div 302 of the *Income Tax Assessment Act 1997* (Cth) ('ITAA 1997'). Relevantly, s 302-10 provides:

- (2) To the extent that 1 or more beneficiaries of the estate who were * death benefits dependants of the deceased have benefited, or may be expected to benefit, from the * superannuation death benefit:
 - (a) the benefit is treated as if it had been paid to you as a person who was a death benefits dependant of the deceased; and
 - (b) the benefit is taken to be income to which no beneficiary is presently entitled.
- (3) To the extent that 1 or more beneficiaries of the estate who were not * death benefits dependants of the deceased have benefited, or may be expected to benefit, from the * superannuation death benefit:
 - (a) the benefit is treated as if it had been paid to you as a person who was not a death benefits dependant of the deceased; and
 - (b) the benefit is taken to be income to which no beneficiary is presently entitled.

Section 302-10 focuses on two questions, namely:

- Are the beneficiaries death benefits dependants?
- To what extent have the relevant beneficiaries 'benefited, or may be expected to benefit' from the superannuation death benefit?

Death benefits dependant

The definition of a *death benefits dependant* is found in s 302-195 of the ITAA 1997. Broadly, a death benefits dependant, of a person who has died, is:

- the deceased person's spouse or former spouse; or
- the deceased person's child, aged less than 18; or
- any other person with whom the deceased person was in an interdependency relationship with just before he or she died; or
- any other person who was a dependant of the deceased person just before he or she died.

If the beneficiary is a death benefits dependant, s 302-10(2) will need to be considered. If the beneficiary is *not* a death benefits dependant, s 302-10(3) will need to be considered.

Benefited, or may be expected to benefit

The tax treatment of death benefits paid to the estate does not simply turn on the number of beneficiaries of the estate who are death benefit dependants versus the number of beneficiaries who are not death benefit dependants. Rather, the tax treatment of any death benefits proceeds that are paid to the estate depends on *the extent* to which death benefit dependants *have benefited or may be expected to benefit* from the proceeds. This will need to be calculated. In some circumstances, particularly where multiple beneficiaries and testamentary trusts are involved, the calculation process will be complex and may require actuarial input.

Tax treatment

Once the calculation is performed, any proceeds paid to the estate from which death benefits dependants have benefited or may be expected to benefit:

- are treated as if they had been paid to a death benefits dependant of the deceased; and
- are not included in the assessable income of the estate (ITAA 1997 s 302-60).

For any death benefits paid to the estate where death benefits dependants do not benefit or may not be expected to benefit, the tax treatment of such proceeds depends on the nature of the lump sum amount that was paid to the deceased's estate. Accordingly, the tax treatment of the super proceeds will be as follows (based on the nature of the lump sum):

Any tax free component of the amount is not included in the assessable income of the deceased's estate (ITAA 1997 s 302-140).

Any taxable component (element taxed in the SMSF) of the amount is included in the assessable income of the deceased's estate, but the estate is entitled to a tax offset to ensure that the rate of income tax does not exceed 15% (ITAA 1997 s 302-145(2)).

Any taxable component (element untaxed in the SMSF) of the amount would be included in the assessable income of the deceased's estate and the estate would be entitled to a tax offset to ensure that the rate of income tax does not exceed 30% (ITAA 1997 s 302-145(3)).

An element untaxed in the fund is rare in an SMSF context and typically only arises if deductions were ever claimed in respect of policy premiums for a life insurance policy held in the SMSF.

For completeness, it should be borne in mind that any death benefits paid to an estate do not attract the Medicare levy.

The following example demonstrates the application of the 'look through' provision and the resulting tax treatment.

EXAMPLE

Alfred was 66 years old when he died. He was a member of Alfred Superannuation Fund. Alfred did not complete a (binding or non-binding) death benefit nomination in respect of his entitlements in the Alfred Superannuation Fund prior to his death. Accordingly, the trustee of the Alfred Superannuation Fund exercises

its discretion and pays Alfred's death benefits to Alfred's estate pursuant to the governing rules of the fund. The sum of \$100,000 that is paid to the estate comprises 50% tax free component and 50% taxable component (element taxed in the Fund).

The beneficiaries named in Alfred's last will are: his wife Diana, his two sons Bruce (17 years old) and Clarke (15 years old), and his best friend Robin (50 years old and not a dependant for tax purposes).

The will provides that Alfred's superannuation death benefits proceeds are to be divided as follows: Diana (\$90,000) and Robin (\$10,000).

Applying the 'look through' provision, Diana, Bruce and Clarke would meet the definition of death benefits dependant under s 302-195 of the ITAA 1997. However, of these death benefits dependants, only Diana may be expected to benefit from the superannuation death benefits proceeds. Accordingly, the \$90,000 to be paid to Diana would not be included in the assessable income of the estate.

The \$10,000 to be paid to Robin will comprise \$5,000 tax free component and \$5,000 taxable component (element taxed in the Fund).

The \$5,000 tax free component is not included in the assessable income of the deceased's estate. The \$5,000 taxable component (element taxed in the Fund) is included in the assessable income of the deceased's estate, but the estate is entitled to a tax offset to ensure that the rate of income tax does not exceed 15% pursuant to s 302-145(2) of the ITAA 1997.

Conclusion

Where any superannuation proceeds are paid to an estate, the tax payable in respect of the death benefit proceeds will depend on whether the ultimate recipient of the superannuation proceeds is a death benefits dependant. This is a complex area of law and where in doubt, expert advice should be obtained.

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