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Dealing with death – Better the devil you know!

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1. Introduction

Often the focus of death benefit planning in SMSFs is around:

- ensuring the death benefit end ups in the desired hands, whether that be by way of a binding death benefit nomination or a reversionary pension or simply left to trustee discretionary powers,

- optimising the tax position of a surviving spouse (ie optimising their transfer balance cap position), and / or

- minimising tax payable on any death benefit payments.

But there's often many ***other*** things that should be considered before a member dies which could add significant value to the SMSF or the underlying beneficiaries, or prevent a massive headache for any surviving trustees, beneficiaries and even SMSF practitioners!

In the accompanying workshop, we will explore various issues that don't often make the headlines but are crucially important to the big picture of death benefit planning and mechanics.

Learning Objectives

After this workshop you will:

- Be able to identify when the death of a member necessitates a change to the trustee structure of an SMSF, and the relevant timeframe if change is required.

- Have analysed issues that could affect an SMSF when a member in receipt of a pension dies. For example:
    - What are the minimum pension payment requirements (if any)?
    - What happens to the tax exemption on investment income for retirement phase pensions?

- Understand how the receipt of a death benefit can affect the financial arrangements of a beneficiary, and identify how their position can be optimised.

- Be able to identify whether a planned course of action aligns with whatever it is that the member is driven by (eg controlling the capital, minimising tax etc).

Glossary of Abbreviations

ABN	Australian Business Number
ACR	Auditor Contravention Report
AFSL	Australian Financial Services Licence
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities & Investment Commission
ATO	Australian Taxation Office
CA	Corporations Act 2001
CC	Concessional Contribution
CGT	Capital Gains Tax
CPD	Continuing Professional Development
DA	Duties Act 1997
ECPI	Exempt Current Pension Income
ETB	Excess Transfer Balance
GST	Goods & Services Tax
GS	Guidance Statement issued by the Auditing and Assurance Standards Board
FHSSS	First Home Saver Super Scheme
ITAA 1997	Income Tax Assessment Act 1997
LCR	Law Companion Ruling (formerly called a Law Companion Guideline) issued by the ATO
LRBA	Limited Recourse Borrowing Arrangement
NALI	Non-arm's Length Income
NCC	Non-concessional Contribution
PAYG	Pay As You Go
PLS	Practitioner Lodgement Service
QC	Quick Code (for referencing publications on ATO website)
SG	Superannuation Guarantee
SGA	Superannuation Guarantee (Administration) Act 1992
SGC	Superannuation Guarantee Charge
SGR	Superannuation Guarantee Ruling
SIS	Superannuation Industry (Supervision) Act 1993
SIS Reg	Superannuation Industry (Supervision) Regulations 1994
SMSF	Self Managed Superannuation Fund
TAA	Taxation Administration Act 1953
TBAR	Transfer Balance Account Report
TRIS	Transition to Retirement Income Stream

2. Trusteeship

Why does a superannuation fund need to have a trustee?

In order to be a *regulated* superannuation fund, a fund must (among other things) have a trustee [SISA s.19(2)] and either [SISA s.19(3)]:

- the trustee must be a constitutional corporation (ie a company or "corporate trustee"), or
- the governing rules of the fund must provide that the sole or primary purpose of the fund is the provision of old-age pensions. In this case, the trustee would be a group of individuals.

Corporations Act requirements when a fund has a corporate trustee

Generally, before we even think about the SMSF definition, if the trustee of a superannuation fund is a proprietary company, the Corporations Act requires the company to have **at least 1** director, and that director must ordinarily reside in Australia [CA s.201A].

If a proprietary company does not meet this requirement, the company will be in breach of the Corporations Act which could result in the company:

- being issued with a Penalty Notice (ASIC can serve a Penalty Notice on the company requiring the company to pay a penalty of $1,062.50), or
- being prosecuted for failing to meet its statutory obligation to have the minimum number of officeholders.

Recap: SMSF definition

There are different rules to satisfy to qualify as an SMSF, depending on whether the fund has a single member or two to four members [SIS s.17A]. These rules are called the "SMSF definition".

Two to Four Members

In order to be an SMSF, a fund with between two and four members must satisfy **all** of the following conditions [SIS s.17A(1)]:

- the fund has fewer than five members, and
- each of the members is an individual trustee (or a director of the corporate trustee), and
- there is no individual trustee (or director of the corporate trustee) who is not a member of the fund, and
- no member is an employee of another member, unless they are relatives. Note that there are a number of different definitions of "relative" in the superannuation law. For the purpose of the SMSF definition, a relative of an individual means [SIS s.17A(9)]:
    - a parent, child, grandparent, grandchild, sibling, aunt, uncle, great-aunt, great-uncle, niece, nephew, first or second cousin of the individual or his or her spouse or former spouse, and
    - a spouse or former spouse of the individual or of an individual listed above, and
- no individual trustee (or director of the corporate trustee) receives remuneration from the fund or any other person for any duties or services performed in their capacity as trustee of the fund.

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Single Member

An individual cannot generally be the sole member and sole individual trustee of an SMSF. If an SMSF has only one member, in general, it must have either [SIS s.17A(2)]:

- a corporate trustee, of which the member is the sole director or the member is one of two directors, or
- two individual trustees, one of whom is the member.

In both cases, the additional individual trustee / director must not "employ" the member unless they are "relatives". No individual trustee / director can receive any remuneration from the fund or any other person for duties or services performed in their capacity as trustee..

The above rules are collectively known as the "basic conditions" that a superannuation fund must meet in order to satisfy the SMSF definition.

Limited exceptions

Note, however, that a fund does not fail to satisfy the SMSF definition above in certain circumstances including [SISA s.17A(3)]:

(a) a **member of the fund has died** and the member's legal personal representative (ie executor or administrator of the estate [SISA s.10(1)] is a trustee of the fund or a director of the corporate trustee of the fund, in place of the member, during the period:

(i) beginning from the date of death, and
(ii) *until* the death benefit starts to be paid out of the fund.

Importantly, note that this special rule does **not** mean that a legal personal representative will automatically become an individual trustee / director of the corporate trustee on the member's death, nor is the SMSF required to restructure its trusteeship / directorship to do this (unless required under the governing rules / constitution).

It just means that if a legal personal representative is appointed as an individual trustee / director of the corporate trustee in place of the deceased member, doing so will not cause the SMSF to fail the SMSF definition.

Also note that if the deceased had joint executors, any or all of those executors could be appointed as an individual trustee / director of the corporate trustee in place of the deceased member without causing the SMSF to fail the SMSF definition. In other words, there is no requirement for there to be a 1 for 1 replacement [SMSFR 2010/2].

Also note that, once appointed, the legal personal representative is a trustee / director of the corporate trustee in their own right with legal powers and responsibilities. Once appointed, the legal personal representative will remain in the role until such time that they resign or are removed as trustee / director of the corporate trustee (in accordance with the governing rules / constitution).

Note also that if the deceased's benefits in the SMSF include a pension that automatically reverted (continued) to a reversionary pensioner on death, there is actually no time between death and the commencement of the payment of the death benefit. In other words, the special rule allowing an executor / administrator of the deceased's estate to temporarily be an individual trustee / director of the corporate trustee would *not* apply.

(b) the legal personal representative of a member of the fund is a trustee of the fund or a director of the corporate trustee of the fund, in place of the member, during any period when:

(i) the member of the fund is under a legal disability, or
(ii) the legal personal representative has an enduring power of attorney in respect of the member of the fund.

When an individual is acting as a trustee / director of the corporate trustee in place of a particular member, they are **not** acting as an "agent" for the member, rather they are a trustee / director of the corporate trustee in their own right with legal powers and responsibilities.

Once appointed, the legal personal representative will remain in the role until such time that they resign or are removed as trustee / director of the corporate trustee (in accordance with the governing rules / constitution).

"6 month rule"

An SMSF generally has a six month period during which it might technically fail the SMSF definition following the death of a member / trustee (or director of a corporate trustee), however, such failure will be disregarded. This effectively provides some time to restructure and remain an SMSF [SIS s.17A(4), SIS s.17A(5)].

The only situation in which this six month rule is **not** available is where new members join an SMSF. A new member must become an individual trustee / director of the corporate trustee (or have an LPR fill that role on their behalf) on the day they become a member.

If a reversionary pensioner is not a pre-existing member at the time of the original pensioner's death, they will need to become a member in accordance with the governing rules of the SMSF.

In addition, they must immediately become an individual trustee / director of the corporate trustee (or have an LPR fill that role on their behalf) on the day they become a member (ie the date of the original pensioner's death).

Death of a trustee / director of a corporate trustee: when does trusteeship / directorship cease?

Note, an individual trustee / director of a corporate trustee will automatically cease to be an individual trustee / director **immediately** on their death.

When does membership for a deceased member cease?

Unlike trusteeship / directorship of a corporate trustee which immediately ceases on death, the **governing rules** of the SMSF will prescribe when a member's membership ceases after their death. Membership could cease, for example:

- immediately on death,
- once death benefits commence to be paid, or
- once all death benefits payable have been made.

Appointing a new trustee / director of a corporate trustee: who has the power to do so?

There are different appointment rules for directors of a corporate trustee vs individual trustees. These are outlined in the table below:

<table>
<tr><th>Corporate trustee</th><th>Individual trustees</th></tr>
<tr><td>If the deceased was the sole director and sole shareholder of the company, their executor / administrator of their estate may appoint another individual as a new director of the company [CA s.201F(2)].

Note that this rule applies to all sole director / sole shareholder corporate trustees. In other words, it is not a rule that can be displaced by the company’s constitution (ie it is not a “replaceable rule”).

A new director will need to be appointed as soon as possible to prevent the penalties outlined above.</td><td>The governing rules or trust deed for the SMSF will generally prescribe who has the power to appoint a new trustee. The governing rules could say, for example, that:
members, or
remaining trustees
may appoint another individual as a trustee.

The governing rules or trust deed will also generally prescribe how the appointment must be effected, for example:
by resolution, or
by deed.
In cases where the governing rules or trust deed do not prescribe the appointment powers / mechanism for effecting an appointment, the Trustee Act of the relevant state will prescribe the appointment powers / mechanism for effecting an appointment of a new trustee.</td></tr>
<tr><td>If the deceased was not the sole director / sole shareholder of the corporate trustee, unless a rule in the company’s constitution states otherwise, the shareholder(s) of the company may appoint another individual as a director by resolution:
passed at a general meeting if there is more than one shareholder [CA s.201G], otherwise
if there is a single shareholder, by the shareholder recording and signing the resolution and signing the record [CA s.249B].</td><td></td></tr>
<tr><td>If the deceased was not the sole director / sole shareholder of the corporate trustee, unless a rule in the company’s constitution states otherwise, the director(s) of the company may also appoint another individual as a director by resolution [CA s.201H].</td><td></td></tr>
</table>

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Who owns the shares in the company (ie corporate trustee)?

As outlined above, shareholders generally have the power to appoint a director of the corporate trustee.

It is therefore important to give consideration to the shareholding of the company, in the context of:

- the number of shares on issue,
- the voting rights of those shares,
- who owns the shares, and
- who will inherit title to the shares when the shareholder dies

in order to prevent the impediment of any planned appointment.

Example 1

Scott and Robin are the members of an SMSF and the directors of the corporate trustee.

They each own 1 share in the corporate trustee (and each have identical voting rights).

When Scott dies, his share will pass to his son Luke (who is also his executor).

If Scott died:

- his directorship would cease and Robin would be the sole director of the company. As a director, she would have power to appoint a new director, and
- his share in the company would form part of his estate and eventually pass to Luke. If the constitution allows, while Scott's estate is being administered Luke (as executor) can exercise Scott's shareholder voting rights (note that most constitutions provide for this, and it is also a principle of estate law). Note that in some states (eg NSW) the executor will need probate before they can exercise this power.

Could Luke be appointed as a director of the company?

Under the "director appointment" route, Robin has the sole power to appoint Luke as a director. What if she doesn't wish to do so?

Under the "shareholder appointment" route, Robin and Luke can each cast 50% of the votes. If Robin doesn't vote in favour of Luke's appointment, he cannot be appointed as a director unless there is specific provision in the constitution that allows a shareholder to appoint a director without majority shareholder approval (note that majority shareholder approval is what most constitutions contain).

Example 2

Roger and Georgie are the members of an SMSF and the directors of its corporate trustee. Roger owns all of the shares in the corporate trustee (2 shares).

On his death, Roger's shares pass to his Georgie and Roger's 2 children (Peter and Mary) in equal shares.

The share registry reports that Georgie, Peter and Mary are **joint** owners of the shares and title to the shares appears as "Georgie and Peter and Mary". Unless the constitution states otherwise, if shares are jointly held only the first named shareholder (ie the oldest by default) is the one who has voting rights.

That could be dangerous (Georgie has sole power to appoint a director – under both the "director route" and the "shareholder route".)

During the planning stages of drafting a will, it may be worthwhile to instead draft the bequest of the shares along the lines of "I bequeath an equal number of shares to each of …". This would ensure each person would be a shareholder in their own right and could exercise their shareholder voting powers.

Example 3

Bruce and Winnie are the members of an SMSF and the directors of its corporate trustee. They each own 1 share in the corporate trustee (there are 2 shares on issue).

Bruce has made a bequest in his will that his 2 children (Greg and Jan) each receive an equal number of his shares on his death. This means that Greg and Jan would each inherit ½ a share in the corporate trustee.

Unless the constitution states otherwise, if each of Greg and Jan's names appears on the share register, they will each get 1 vote. As Winnie owns a share in her own name, this means that 3 votes could be cast at a shareholder meeting and Greg and Jan could outvote Winnie (ie 2 of their votes vs her 1 vote), despite her holding 50% of the shares in the company [CA s.250E, s.9, s.231].

In order to prevent this happening, during the planning stage it may be worthwhile considering splitting the shares so that each of Bruce and Winnie own 2 shares (4 in total) so that Winnie can't be outvoted.

A good general rule of thumb for the number of shares to issue to each party is:

- calculate the number of beneficiaries that are to inherit shares (say there are 3 adult children that will ultimately inherit everything from their parents),
- multiply that number by the number of directors (say there are 2 directors),
- have the company issue that number of shares (ie 3 children x 2 directors = 6 shares), and
- each director holds an equal number of shares in the company (ie 3 shares each).

This means the remaining shareholder and the new "group" of shareholders each have equal rights (and the remaining shareholder is no worse off).

3. Death of a member in receipt of a pension

Minimum pension payment requirements

The minimum required pension payment for a particular income or financial year is generally only ever calculated [SIS Reg 1.06(9A)(a), SIS Reg Schedule 7, SIS Reg 1.06(8), SIS Reg Schedule 6, SIS Reg 1.06(4), SIS Reg Schedules 1A and 1AAB]:

- on the **commencement day** of the pension, and thereafter
- every **1 July** while the pension remains in place

and the "drawdown factor" used to calculate the minimum pension payment corresponds to the age last birthday of the pensioner at that time.

(Note that in the case of a legacy defined benefit pension that commenced on any day *other than* 1 July, the relevant "year" is not the standard income or financial year, rather it is the 12 month period that commenced on the day the pension started, and thereafter it is the 12 month period that commences on the anniversary of the commencement date. Note that legacy defined benefit pensions are beyond the scope of this paper).

The minimum pension requirements that apply to a **pension that had been in payment to a deceased member** depend on whether the pension reverted to another beneficiary, or whether the deceased's pension ceased on their death.

When is a pension a "reversionary" pension"?

In Law Companion Ruling (LCR) 2017/3, the ATO provides its view on what constitutes a "reversionary" pension versus what doesn't.

A reversionary pension is a pension:

- that **continues** with the entitlement to the pension passing from one person (the pensioner) to another (a dependant beneficiary) [LCR 2017/3 para 12], because
- the terms and conditions of the pension expressly provide for reversion (and these terms and conditions were in place prior to the pensioner's death), as opposed to the trustee exercising a power or discretion to determine to pay a benefit [LCR 2017/3 para 13].

In contrast, a pension is non-reversionary if the fund trustee has the power or discretion to determine [LCR 2017/3 para 15]:

- to **whom** the death benefit is paid,
- the **form** in which the death benefit will be paid (eg lump sum death benefit or pension), or
- the **amount** of the death benefit paid.

The ATO had earlier provided guidance [TR 2013/5] that where the trustee has a **continuing** liability to make pension payments from the pension, albeit the recipient of the pension payments changes from the deceased member to the dependant beneficiary, the pension does not cease, rather it **automatically** transfers to the dependant beneficiary [TR 2013/5 para 125]. Once again, any discretionary powers exercisable by the trustee in relation to determining who will receive the death benefit(s) and / or the form in which the death benefits would be payable would **not** constitute an automatic transfer of the deceased's pension to a dependant beneficiary [TR 2013/5 para 126].

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It *may* be possible for a binding death benefit nomination to make a non-reversionary pension reversionary. The critical determinants would be that the:

- pension **automatically** continues, without
- the trustee having the ability to exercise any power or discretion for it to do so.

Minimum pension requirements in the year of death: pension reverts to a reversionary pensioner

If the deceased member's pension **was** reversionary, the minimum pension calculated on 1 July of the year of death (or the commencement date if the pension commenced in the year of death) must be paid **by 30 June** of that year.

This means that by 30 June the **aggregate** of pension payments made to the:

- deceased member, **and**
- the reversionary pensioner

must be equal to or greater than the minimum required pension payment.

Importantly, note that in the year of the pensioner's death there is **no requirement** to:

- pay a pro-rated minimum pension payment to the deceased pensioner prior to their death – it is perfectly acceptable for all of the pension payments to be paid to the reversionary pensioner. Likewise, there is no requirement to pay a pro-rated minimum pension payment to the reversionary pensioner if the payments made to the deceased pensioner satisfy the required minimum, and
- recalculate the minimum pension payment in the year of death – what was calculated on 1 July / commencement date (if the pension commenced in the year of death) is fixed and remains unchanged for the year of death.

Example 4

Joe (81) had an account-based pension that automatically reverted to his wife Mary (73) on his death.

The balance of Joe's account-based pension on 1 July just prior to his death was $1m and the minimum pension payment for the year was calculated as $70,000 (ie $1m x 7%). The drawdown factor used in this calculation was based on Joe's age last birthday on 1 July (ie 81) just prior to his death.

As long as $70,000 is drawn from the pension by 30 June in the income year of Joe's death the minimum pension requirement will have been met. The $70,000 could have been comprised

- $70,000 paid to Joe himself prior to his death,
- $70,000 paid to Mary after Joe's death, or
- some $ paid to Joe himself prior to his death with the remainder paid to Mary after Joe's death – at least $70,000 (combined) in *any* combination must have been paid to Joe and / or Mary.

Note that in the case of account-based pensions, transition to retirement pensions or legacy allocated pensions (*not* "term" allocated or market linked pensions), the drawdown factor used to calculate the minimum pension payable in each **subsequent** year is based on the *reversionary* pensioner's age last birthday at that time. In other words, for the purposes of calculating the minimum pension payable in the income years after the deceased pensioner's death, the *age* of the deceased pensioner is no longer relevant.

Note that the minimum pension payable for a "term" allocated pension / market linked pension is based on a drawdown factor that corresponds to the remaining "term" of the pension at that time. The age of the pensioner / reversionary pensioner is not relevant when calculating the minimum (and maximum) pension payments for these pensions.

Example 5

Revisiting Mary from the previous example.

It is now 1 July of the year after Joe's death. Mary is now 74 and the balance of the account-based pension that reverted to her on Joe's death is now $1.01m.

The minimum pension payment required for the year after Joe's death will be $1.01m x 5% (ie drawdown factor based on *Mary's* age last birthday), rounded to the nearest $10.

Minimum pension requirements in the year of death: pension does not revert to a reversionary pensioner

In the case of a non-reversionary pension, the pension will cease on the pensioner's death and no further pension payments are payable from that pension from that time.

Ordinarily, when a pension ceases (eg a pension is commuted) a pro-rated minimum pension payment must be paid to the pensioner prior to the commutation. An **exception** to this requirement, however, exists in cases where a **non-reversionary pension ceases because of the death of the pensioner** [SIS Reg 1.06(9A)(a), SIS Reg 1.07D(1)(a)] [SIS Reg 1.06(8)(b), SIS Reg 1.07C(2)(a)] [SIS Reg 1.06(4)(f), SIS Reg 1.07A(2)(a)] [SIS Reg 1.06(2)(b), SIS Reg 1.06(7)(c), SIS Reg 1.06(6)(b), SIS Reg 1.07B(3)(a)].

If a non-reversionary pension ceases because of the death of the pensioner, there is **no requirement** for a pro-rated minimum pension to have been paid prior to the cessation of the pension.

Example 6

Cecily (76) had an account-based pension and its balance on 1 July was $1m. The minimum pension payment for the year was calculated as $60,000 (ie $1m x 6%). The drawdown factor used in this calculation was based on Cecily's age last birthday on 1 July.

Cecily died yesterday and the pension did not revert to a reversionary pensioner, rather it ceased on her death.

In the income year to date, she had not drawn any pension payments at all. Despite this, the pension has met the pension payment standards for the income year.

Retirement phase pensions: tax exempt investment income

Reversionary pensions

When a pensioner dies and their pension reverts to a reversionary pensioner, a tax exemption on the investment income generated by assets supporting the pension will either:

- **continue seamlessly** if the pension had been in retirement phase at the time of the pensioner's death, or
- **commence immediately** on the death of the pensioner if the pension had been a pre-retirement phase pension in the hands of the deceased pensioner.

Non-Reversionary pensions

Prior to December 2018, when a pensioner died, the tax exemption on investment income for any **non**-reversionary retirement phase pension continued seamlessly from the date of the pensioner's death until the date the death benefit was dealt with, ie until the date:

- lump sum death benefit(s) were paid, and / or
- death benefit pension(s) were commenced

as long as:

- nothing, apart from investment earnings, had been added to the pension balance from where the death benefit was sourced, and
- the death benefit was dealt with **as soon as practicable**.

[per former definition of "superannuation income stream benefit" ITA Reg 995-1.01(3) and (4)].

In December 2018, however, the taxation law was changed [Treasury Laws Amendment (Miscellaneous Amendments) Regulations 2018] and the requirement to deal with a death benefit as soon as practicable in order to retain the tax exemption on investment income was removed with effect from the 2012/13 year (ie the date the extension of the tax exemption on investment income for non-reversionary pensions was enacted) [per new definition of "superannuation income stream benefit" ITA Reg 995-1.01(2) - (4A)].

Our discussions with the ATO indicate that this change was made simply to streamline the taxation laws.

Does this mean the tax exemption on investment income would continue indefinitely after the pensioner's death?

Yes. The removal of the "as soon as practicable" requirement under the taxation law means that the tax exemption on investment income will continue from the date of death until such time that the death benefit payable from the non-reversionary pension interest is dealt with – whenever that is.

Note, however, that there has been no change to the superannuation law – ie death benefits must be cashed "as soon as practicable" after the member dies [SIS Reg 6.21(1)]. In other words, the compulsory cashing requirement will be contravened if the trustee allows the deceased's pension balance to remain in the fund after a time when it became practicable to cash it [LCR 2017/3 para 64(a)]. Failure to do so would contravene the benefit payment standards [SIS Reg 6.17] (which may need to be reported to the ATO by the auditor via an Auditor Contravention Report) and the operating standards [SIS s.31] of SIS.

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Our discussions with the ATO indicate that it would not look favourably on funds (in its role as Regulator of SMSFs) where death benefits are not cashed as soon as practicable in order to deliberately prolong the tax exemption on investment income. Rather, such deliberate action could lead to trustee administrative penalties or the removal of the fund's complying status, and disqualification of the trustees.

Given the removal of the "as soon as practicable" requirement in the taxation law, what are the differences between a reversionary pension and a non-reversionary pension?

Previously, one of the benefits of making a pension reversionary was that, in cases where the reversionary pensioner ultimately had to commute some or all of their own pension(s) or reversionary pension(s) on or before the 12 month anniversary of the pensioner's death in order to not exceed their transfer balance cap, the reversionary pensioner could have been in receipt of two "sets" of pensions (ie their own and also the reversionary pension(s)) for a full 12 months - enabling the fund to claim the highest possible tax exemption on its investment income over that 12 month period.

A similar result could now be achieved with a non-reversionary pension given that the tax exemption on investment income will continue until the death benefit is dealt with – arguably, in cases where there is no binding death benefit nomination directing the trustee, the trustee could simply take around 12 months to decide what to do with the deceased's non-reversionary pension balance (as long as this met the "as soon as practicable" requirement in the superannuation law).

The ATO had previously stated its view [QC 42934] that, as a general rule of thumb, it expects that 6 months is more than enough time for most SMSFs to cash a death benefit. In cases where this is not able to occur, the ATO suggested the trustees document the *reasons* why the death benefits were unable to be cashed within that time. Doing so would provide evidence that, ultimately, the death benefit was cashed as soon as it was practicable to so.

With this in mind, maximising tax exempt investment income may no longer be a decisive factor in deciding whether or not to make a pension reversionary. For some clients, the *other* differences between a reversionary pension and a non-reversionary pension may have a greater impact on the decision whether to make a pension reversionary or not.

Other differences between a reversionary pension and a non-reversionary pension

A reversionary pension:

- is "owned" by the reversionary pensioner immediately upon the original pensioner's death,
- is not counted against the reversionary pensioner's transfer balance cap until the 12 month anniversary of the original pensioner's death,
- the value that "counts" towards the transfer balance cap will be the value at the date of death, not the value on the 12 month anniversary, and
- the tax free and taxable proportions that apply to the reversionary pension are the same as those that applied to the original pension.

A non-reversionary pension:

- will cease on the death of the pensioner, and "ownership" of any remaining pension balance will not immediately pass to a beneficiary. Rather, ownership will pass once the trustee decides how to deal with the death benefit (in cases where there is no valid binding death benefit nomination), or once the trustee deals with a death benefit as directed (in cases where there is a valid binding death benefit nomination),
- if cashed in the form of a death benefit pension to an eligible recipient, the value of the pension on its commencement day will count towards the recipient's transfer balance cap on that commencement day, and
- the tax free and taxable proportions that apply to the death benefit pension are calculated on the commencement day based on the underlying tax components of the source balance on that day.

Ownership of a pension balance: what can it effect?

As outlined above, a reversionary pension is "owned" by the reversionary pensioner immediately upon the original pensioner's death, however, ownership of a non-reversionary pension will only pass to a beneficiary once the trustee decides how to deal with the death benefit (in cases where there is no valid binding death benefit nomination), or once the trustee deals with a death benefit as directed (in cases where there is a valid binding death benefit nomination).

Once a member "owns" a pension balance, it will be included in their **"total superannuation balance"** at the next 30 June. In the case of a reversionary pension, the value of the pension balance will be included in their total superannuation balance at the 30 June immediately following the deceased's death and may affect the reversionary pensioner's:

- non-concessional contributions cap,
- ability to trigger a bring forward of non-concessional contributions, or complete a bring forward that is mid-stream,
- ability to use any unused concessional contributions carried forward from earlier years (ie carried forward from 2018/19, for a maximum of 5 income years), and
- ability to make work test exempt contributions

in the income year following the deceased's death.

It may also affect *how* an SMSF is required to calculate its tax exempt investment income (ie which method(s) are to be used – actuarial certificate method, segregated method, both). In the case of a reversionary pension, it may affect the method by which the tax exempt investment income is calculated in the income year following the deceased's death.

Example 7

Brett (62) had a pre-retirement TRIS in place when he died. Brett's TRIS was reversionary and consequently it automatically continued to his wife Kristy (in retirement phase) upon his death.

The value of the TRIS at the time of death was $1m (100% taxable component). This amount will count towards Kristy's transfer balance cap on the 12 month anniversary of Brett's death.

On 30 June immediately after Brett's death, Kristy's total superannuation balance includes:

- the reversionary TRIS (valued at just over $1m), and
- her accumulation account (valued at just under $900,000).

As Kristy's total superannuation balance at that 30 June is more than $1.6m, her non-concessional contributions cap for the following year is $Nil.

If instead:

- Brett's TRIS was *not* reversionary to Kristy, and
- no death benefit pension had commenced for Kristy,

her total superannuation balance at 30 June immediately after Brett's death would be valued at just under $900,000 (ie her accumulation account only). As this is less than $1.6m, Kristy:

- has a non-concessional contributions cap of $100,000, and
- could trigger the bring-forward (as long as she met the other eligibility requirements) and make non-concessional contributions of $300,000

in the following income year.

This may be useful if Kristy would like to, say, recycle some of Brett's superannuation and convert it from taxable component to tax free component. A tax free lump sum death benefit could be paid to Kristy, which is then used to make non-concessional contributions.

Doing so may be beneficial to Kristy if:

- she is under age 60,
- the tax rules change in the future and tax is reintroduced for those aged 60 or over, or
- if non-death benefits dependants inherit her superannuation on her death.

Example 8

Paul (85) and his wife Pat (79) each had an account-based pension within their SMSF with balances of around $0.3m and $1.5m respectively.

Last 30 June, no member of the SMSF had both a retirement phase pension and a total superannuation balance of more than $1.6m. This means the SMSF is not prohibited from using the segregated method for calculating its tax exempt investment income this year, and *all* of the SMSF's investment income will be exempt from tax under the segregated method.

If Pat died today and her pension reverted to Paul, his total superannuation balance will be around $1.8m next 30 June. As Paul would have both a retirement phase pension and a total superannuation balance of more than $1.6m next 30 June, the SMSF will be prohibited from using the segregated method for calculating its tax exempt investment income next year – it must instead obtain an actuarial certificate and a portion of the SMSF's investment income would be exempt from tax.

If Pat's pension had *not* been reversionary to Paul and no death benefit pension had commenced for him, his total superannuation balance next 30 June will be around $0.3m. As Paul would **not** have both a retirement phase pension and a total superannuation balance of more than $1.6m next 30 June, the SMSF will be **not** be prohibited from using the segregated method for calculating its tax exempt investment income next year – rather all of the investment income will be exempt from tax under the segregated method (remember the tax exemption will continue to apply to Pat's former pension balance until it is dealt with).

This may be extremely useful if, say, large capital gains were expected to be realised in the year after Pat's death because, say:

- Paul wished to wind up the SMSF, or
- the investment strategy of the SMSF was amended and various assets were sold to align with the new strategy.

But … remember your sanity check. If Pat's pension had been reversionary to Paul and the SMSF was required to use the actuarial certificate method in the following year to claim its tax exemption on investment income, the tax exempt % may be quite high if Paul had a large part of his transfer balance cap available to use, and if any amount he rolled back to accumulation phase from his own account-based pension occurred late in the year.

Should a reversionary pensioner nomination ever be removed?

As outlined above, inheriting a reversionary pension may affect the reversionary pensioner's:

- non-concessional contributions cap,
- ability to trigger a bring forward of non-concessional contributions, or complete a bring forward that is mid-stream,
- ability to use any unused concessional contributions carried forward from earlier years (ie carried forward from 2018/19, for a maximum of 5 income years), and
- ability to make work test exempt contributions

in the income year following the deceased's death, and it may also affect the method used by the SMSF to calculate its tax exempt investment income.

It is therefore worth reviewing whether a reversionary pensioner nomination should be retained versus removed as, in some cases, making the pension non-reversionary may now be more attractive as it may create other opportunities that may not be available if the pension remained reversionary.

Other instances where it may be worthwhile to removing a reversionary pensioner nomination are outlined below.

Pension balance expected to decrease in the 12 months after death

If the value of a pension account balance is expected to decease as a result of either:

- negative investment returns, or
- pension payments after death

it may be worth considering the *removal* of a reversionary pensioner nomination. This is because the amount that would count towards the reversionary pensioner's transfer balance cap on the 12 month anniversary of the original pensioner's death would be *higher* than the amount that would apply if the pension had not reverted, and a new death benefit pension had instead been commenced. This may enable the beneficiary to maximise the amount held in a retirement phase pension, or indeed within the superannuation environment.

Example 9

Sam has a retirement phase pension in his SMSF with a current value of $1.4m (all taxable component). It incorporates his wife (Mitzi) as the reversionary pensioner.

Mitzi has not, to date, commenced any retirement phase pensions from her accumulation account.

One of the investments in the SMSF is quite risky, and it's highly likely to decrease in value in the next year or so. The asset is also illiquid and, given its current state of volatility, the SMSF is unable to sell the asset.

Sam unfortunately dies.

The amount that will count towards Mitzi's transfer balance cap in 12 months' time will be $1.4m (ie the value of the pension account balance at the date of death), regardless of what its actual value is at that time.

In the 12 months after Sam's death, the value of the underlying asset falls substantially and, as a result, the reversionary pension payable to Mitzi depreciates significantly in value to $400,000.

Mitzi has effectively "used" $1m of her transfer balance cap (ie $1.4m value of the reversionary pension at the date of Sam's death less the actual value of the pension balance 12 months later of $400,000), despite not receiving any financial benefit from that amount.

If Sam had instead removed his reversionary pensioner nomination prior to his death, and the trustee had instead decided to pay a new death benefit pension to Mitzi from Sam's former pension balance some time after the asset devaluation had been taken into account, only $400,000 would count towards Mitzi's transfer balance cap. Mitzi would therefore have $1.2m of her transfer balance cap (ie $1.6m transfer balance cap less the value of the death benefit pension when it commences) available for use in the future.

Example 10

Shweta has a retirement phase pension in her SMSF with a current value of $1.8m (all taxable component). It incorporates her husband (Andy) as the reversionary pensioner. The minimum required pension payment for the current year is $90,000.

Andy has not, to date, commenced any retirement phase pensions from his accumulation account.

Shweta unfortunately dies.

Andy withdraws numerous pension payments (totalling $700,000) in the 12 months after Shweta's death, some of which he uses to pay off the remainder of his mortgage. He pays no tax on these pension payments because Shweta was over 60 when she died.

The actual balance of the reversionary pension 12 months after Shweta's death is around $1.12m.

Despite this, $1.8m (ie the value of the pension at the date of death) will count towards Andy's transfer balance cap on the 12 month anniversary of Shweta's death. As this will exceed his transfer balance cap, he will be required to partially commute the pension and draw a lump sum payment of $200,000 on or before that date in order to not exceed his cap.

If Shweta had instead removed her reversionary pensioner nomination prior to her death, the trustee could have decided to cash her death benefits as:

- a lump sum death benefit to Andy for $700,000 (which he could have used to pay off the remainder of his mortgage), and
- a death benefit pension to Andy with the remainder of Shweta's (former) pension balance (worth around $1.12m).

If this had occurred:

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- Andy would not exceed his transfer balance cap – on the contrary, he would have close to $500,000 of cap space still available for use,
- Andy would be in exactly the same personal tax position – ie any pension payments paid to him would be non-assessable non-exempt income (ie tax free) as would any lump sum death benefit paid to him, and
- the tax exemption on the fund's investment income (because of the existence of Shweta's retirement phase pension) would continue after her death until her death benefits are dealt with – in other words, the SMSF is in virtually the same position had the pension been reversionary.

Note, a similar result could have been achieved if Andy instead partially commuted the reversionary pension as this would "claw back" some of his transfer balance cap. Note, however, that:

- the minimum annual required pension of $90,000 would need to be drawn from the reversionary pension as *pension* payments – in other words this amount could not be clawed back to create cap space, and
- Andy took numerous payments. Given the current concern within the superannuation industry that any third or subsequent lump sum death benefit payment (including those from the partial commutation of a reversionary or death benefit pension) would not comply with the compulsory cashing rules, Andy may not have the ability to partially commute and withdraw a lump sum payment from the reversionary pension more than twice.

Example 11

The value of Dan's retirement phase pension was $1.7m when he died around 11 months ago. It is now worth around $1.5m due to a devaluation of the fund's assets. The SMSF trustee is now in a position to cash Dan's death benefits.

Dan's wife Steph does not have a transfer balance account as yet, as she has never been in receipt of a retirement phase pension. She therefore has the full amount of her transfer balance cap available for use.

If Dan's pension **had** been reversionary to Steph:

- the fund's tax exemption on its investment income would have continued seamlessly,
- Steph would have assumed ownership of the pension immediately upon Dan's death (ie it would be included in her total superannuation balance),
- the minimum pension requirements for the pension would need to be met by 30 June after Dan's death (and each 30 June thereafter). If Dan had not taken any pension payments in the income year prior to his death, Steph would need to draw the full minimum by 30 June in the year of Dan's death,
- $1.7m (ie the value when Dan died) would count towards Steph's transfer balance cap on the 12 month anniversary of Dan's death. Steph would be required to commute $100,000 on or before that time to ensure she did not exceed her transfer balance cap, and the commuted amount would need to be withdrawn from the superannuation environment as a lump sum death benefit.

In contrast, if Dan's pension had **not** been reversionary to Steph:

- the fund's tax exemption on its investment income would continue during the 11 month period between Dan's death and the date the death benefits are cashed,

- Steph does not "own" Dan's former pension balance, and it is therefore not included in her total superannuation balance, until such time that the trustee decides to cash the balance in her favour,
- no minimum pension payments are required in the year of Dan's death, nor are any pension payments required until such time that a death benefit pension is commenced for Steph. This may mean that less $ leave the superannuation environment, and
- if the death benefit is cashed in the form of a death benefit pension payable to Steph, $1.5m would count towards Steph's transfer balance cap on the day the death benefit pension commences - which would fall within her transfer balance cap.

Want someone other than the reversionary pensioner to inherit any amount in excess of the reversionary pensioner's transfer balance cap?

In some cases, where the reversionary pensioner is unable to create enough transfer balance cap space to absorb all of the deceased's superannuation, the "excess" must be removed from superannuation by withdrawing a lump sum death benefit. As the reversionary pensioner "owns" any pension balance that reverts to them, the lump sum death benefit must be paid to *them* and is not able to be paid to any other beneficiary, or the deceased's estate.

Example 12

Craig's account-based pension has skyrocketed in value in the last year or so as a result of one of the SMSF's assets listing on the ASX – it is currently valued at around $10m.

Meanwhile, Melissa's account-based pension in her industry fund is currently worth around $1m (and the balance of her transfer balance account is $1.1m).

Each of their pensions are reversionary to the other.

If Craig were to die, his pension would automatically continue to be paid to Melissa (ie she would "own it"). She could create *some* cap space (ie $1.5m) by rolling her own account-based pension back to accumulation, ie:

- $1.6m transfer balance cap, less
- the balance of her transfer balance account which has reduced from $1.1m to $100,000 as a result of rolling back her own account-based pension

but it would not be enough to absorb the value of Craig's account-based pension if he were to die today ($10m). The lump sum death benefit payable to Melissa would be in the order of $8.5m.

If, say, they wished for the "excess" to be paid to Craig's estate where it would ultimately pass to a testamentary trust upon completion of the administration of the estate (for asset protection purposes for Melissa, or for income splitting purposes for the family group) it would not be possible as ownership of Craig's pension has passed to Melissa.

If Craig, however, removed his reversionary pensioner nomination, his pension could be cashed in the form of:

- a death benefit pension to Melissa, and / or
- a lump sum death benefit to any of his SIS dependants or his estate.

This may be attractive if:

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- the value of Craig's (former) pension is unlikely to grow much in value in the 12 months after his death – as one of the benefits of a reversionary pension is that it is the date of death value that "counts" for transfer balance cap purposes, and
- the cost of paying any lump sum death benefit to anyone other than Melissa (ie any lump sum death benefit paid to her will be tax free) is outweighed by the benefits of future tax savings that may be achieved by holding the excess $8.5m in a vehicle that was taxed more concessionally than marginal rates of tax.

4. How can receipt of a death benefit affect the financial arrangements of a non-death benefits dependant beneficiary?

Beneficiary receives a lump sum directly from a superannuation fund

Tax treatment of the lump sum death benefit

A lump sum death benefit paid directly to a non-death benefits dependant (ie a non-dependant for tax purposes) is taxed as follows:

- any tax free component is non-assessable non-exempt income (ie tax free) [ITAA 1997 s.302-140], and
- any taxable component is **included in the recipient's assessable income** and taxed at their normal marginal tax rate. A tax offset [ITAA 1997 s.302-145] will, however, apply to reduce the maximum tax rate to:
    - 15% on the "taxed" element, and
    - 30% on the "untaxed" element.

Generally in an SMSF, there will only be an untaxed element where [ITAA 1997 s.307-290]:

- the deceased was under age 65 at the time of death,
- the trustee has claimed a tax deduction for insurance premiums for insurance cover over the deceased's life, or has claimed the "future service" deduction (ie a special deduction which some funds choose to claim in the year a member dies as an alternative to claiming deductions for future insurance premiums [ITAA 1997 s.295-470]), and
- the insurance policy is still in effect at the time of death [Private Binding Ruling 1011817026582].

The amount of the untaxed element is derived from a formula and essentially represents the "future service" component of the lump sum payment (ie it is a notional proportion of the overall benefit representing the number of days remaining to age 65 compared to the member's total days in superannuation if they had lived to 65). The amount of the untaxed element will diminish as the member ages, reaching $Nil at age 65.

Note that the same methodology applies regardless of whether the beneficiary is an Australian resident for tax purposes or a foreign resident for tax purposes. Different rates of tax will, however, apply to Australian residents versus foreign residents for tax purposes.

The tax rates for 2019/20 are outlined in the tables below.

Resident tax rates (excluding Medicare levy of 2%)	
Taxable income	**Tax on this income**
0 – $18,200	Nil
$18,201 – $37,000	19c for each $1 over $18,200
$37,001 – $90,000	$3,572 plus 32.5c for each $1 over $37,000
$90,001 – $180,000	$20,797 plus 37c for each $1 over $90,000
$180,001 and over	$54,097 plus 45c for each $1 over $180,000

If the beneficiary is an Australian resident for tax purposes, the **Medicare levy** will also effectively apply to the taxable component. The Medicare levy generally applies to an individual's *taxable* income (ie assessable income (including the taxable component of any lump sum death benefit) less deductions) unless an exemption applies.

Non-resident tax rates	
Taxable income	**Tax on this income**
0 – $90,000	32.5c for each $1
$90,001 – $180,000	$29,250 plus 37c for each $1 over $90,000
$180,001 and over	$62,550 plus 45c for each $1 over $180,000

A non-death benefits dependant beneficiary will need to provide their **TFN** to the trustee of the superannuation fund that is paying the lump sum death benefit. Unless they already have a TFN, foreign tax residents can apply for one using NAT 2628 (in Section C, choose Option 5).

Example 13

In 2019/20, Kylie received a lump sum death benefit of $575,000 from her father's superannuation as a result of his death. Kylie was not a death benefits dependant of her father. The lump sum death benefit was comprised of:

- Tax free component: $75,000
- Taxable component (all taxed element): $500,000

In 2019/20, Kylie had other assessable income of $97,332 (ie from her salary, bank interest, dividends etc) and deductions of $3,000.

Kylie's assessable income in 2019/20 would be $597,332 (ie $500,000 taxable component of the lump sum death benefit plus her other assessable income of $97,332), and her taxable income would be $594,332 (ie $597,332 assessable income less $3,000 deductions).

Kylie is an Australian resident for tax purposes.

Using the usual marginal tax rates, Kylie would ordinarily pay tax of $240,546.40 on her taxable income.

Kylie would, however, be entitled to a tax offset of $143,146.56, calculated as outlined below:

Taxable income (including lump sum death benefit)	$594,332	Tax payable on taxable income (including lump sum death benefit)	$240,546.40
Taxable income (excluding lump sum death benefit)	$94,332	Tax payable on taxable income (excluding lump sum death benefit)	($22,399.84)
Prima facie tax payable on lump sum death benefit			**$218,146.56**
Maximum tax payable on lump sum death benefit ($500,000 x 15%)			($75,000.00)
Tax offset			$143,146.56

After allowing for the tax offset, Kylie would have net tax payable of $97,399.84 (ie $240,546.40 - $143,146.56), of which $75,000.00 is attributable to the taxable component of the lump sum death benefit.

As an Australian resident for tax purposes, Kylie would also be liable for Medicare levy of $11,886.64 (ie 2% x her taxable income of $594,332). This essentially means that the Medicare levy attributable to the lump sum death benefit is $10,000 (ie 2% x $500,000 taxable component).

Kylie's brother Brendan also received a lump sum death benefit of $575,000 in 2019/20 from his father's superannuation as a result of his death. As was the case for Kylie, Brendan was not a death benefits dependant of his father.

The lump sum death benefit paid to Brendan was also comprised of:

- Tax free component: $75,000
- Taxable component (all taxed element): $500,000

Brendan is **not** an Australian resident for tax purposes, and he had no other income assessable in Australia, nor any deductions.

Using the usual marginal tax rates for non-residents, Brendan would ordinarily pay tax of $206,549.55 on his taxable income.

Like Kylie, Brendan would be entitled to a tax offset calculated as outlined below:

Taxable income (including lump sum death benefit)	$500,000	Tax payable on taxable income (including lump sum death benefit)	$206,549.55
Taxable income (excluding lump sum death benefit)	$0	Tax payable on taxable income (excluding lump sum death benefit)	($0.00)
Prima facie tax payable on lump sum death benefit			$206,549.55
Maximum tax payable on lump sum death benefit ($500,000 x 15%)			($75,000.00)
Tax offset			$131,549.55

After allowing for the tax offset, Brendan would have net tax payable of $75,000.00 (ie $206,549.55 - $131,549.55).

Unlike Kylie, as Brendan is **not** an Australian resident for tax purposes, he would not be liable for Medicare levy.

Comparing Kylie's "in the hand" death benefit to Brendan's, Brendan would be $10,000 better off than Kylie (as he was not liable for the Medicare levy).

Other benefits and costs of that may be affected by taxable income

In addition to the imposition of the Medicare levy, a non-death benefits dependant may:

- lose various other "benefits", or
- have additional "costs" imposed

in cases where the eligibility or assessment criteria for those benefits or costs include an "income test".

Eligibility for certain "benefits" that may be affected by the level of the recipient's taxable income (together with adjustments to taxable income in some cases) include:

- Family tax benefit, child care subsidy and child care benefit, paid parental leave,
- Low income tax offset, Low and middle income tax offset, Seniors and pensioners tax offset,
- Government co-contributions, low income superannuation tax offset, spouse contributions tax offset, and
- Commonwealth Seniors Health Care Card (note that if the income for a particular income year is above the relevant income threshold, and the CSHC holder / applicant can show that the source of increased income is of a "one-off" nature, an estimate of income *may* be acceptable in some cases).

Note that lump sum death benefit payments received are **not** included in income tests used to determine eligibility for various social security pensions (eg age pension, disability support pension) or allowances (eg Newstart).

"Costs" that may be imposed as a consequence of an increase in the recipient's taxable income (together with adjustments to taxable income in some cases) include:

- Division 293 tax (ie an additional 15% tax) on concessional contributions to superannuation,
- Medicare levy, Medicare levy surcharge, private health insurance rebate, and
- An increased "repayment rate" for study and training loans (eg higher education loan program (HELP)).

Lump sum death benefit paid to the deceased's estate

Once an individual dies, any income received *after* the date of death will be income of the deceased's estate and will generally be assessed as income of the deceased's executor or administrator in each income year *before* the administration of the estate is complete. In other words, any income received before administration of the estate is completed is generally *not* assessed as income of the underlying beneficiaries of the estate. (Note that an exception to this applies in cases where, prior to completion of the administration of the estate, the executor identifies that part of the net income of the estate is not required to either pay or provide for debts or specific bequests etc, and the executor pays some of the income to beneficiaries. If this occurs, the beneficiaries *will* be assessed on the income in relation to the amounts actually paid to them).

During administration, marginal rates of tax [ITAA 1936 s.99] apply to income of the estate as follows [ITRA 1986 Sch 10 Part 1]:

- where the deceased died less than 3 years before the end of the income year, ordinary progressive marginal rates of tax will apply, otherwise
- ordinary progressive marginal rates of tax will apply with the exception of the tax-free threshold – ie it is not available.

Note that an estate will be fully administered (ie complete) when:

- all of the assets and liabilities have been ascertained,
- payment, or provision for payment, for any debts incurred by the deceased or debts incurred by the estate has been made, and
- distribution of *specific* assets or bequests has been made or provided for.

Until such time that an estate is fully administered, the residue of the estate cannot be ascertained with certainty, and no *residual* beneficiary has present entitlement to income [IT 2622 paras 9 - 13].

Once a beneficiary has present entitlement to income, the *beneficiary* will be assessed on that income.

Note, however, that a lump sum death benefit paid to the deceased's estate is **always** income to which no beneficiary is presently entitled [ITAA 1997 s.302.10, ITAA 1936 s.101A(3)].

This means the taxable portion of a lump sum death benefit paid to a deceased estate will be **assessable income to the estate** and the marginal rates (as outlined above) will apply – it will have no effect on the assessable income of any underlying beneficiary.

Whether a beneficiary is presently entitled to a share of income of the estate is determined on the last day of the income year [IT 2622 para 19]. In addition, the net income of the estate is also determined on the last day of the income year [IT 2622 para 19]. This means that, on the last day of the income year:

- if a beneficiary has become presently entitled to a share of the income of the estate on or before that day, the beneficiary is personally assessed on that share of the net income of the estate [calculated in accordance with ITAA 1936 s.95], and
- the amount of the net income of the estate includes **all** the assessable income of the estate in that income year [ITAA 1936 s.95].

That said, in cases where the executors and beneficiaries are able to demonstrate the actual amounts of income derived in the periods before and after the day on which the estate was fully administered, the longstanding practice of the ATO is to accept an apportionment in the income year in which the estate is fully administered [IT 2622 para 21].

Where does probate fit in?

Until probate is obtained, the executor does not hold legal title to the deceased's assets and does not have authority to deal with the assets of the deceased's estate.

Following the grant of probate, the legal right of any *presently entitled* beneficiaries to income earned by the estate will be recognised by the ATO. This means that those beneficiaries *would* be personally assessed on their share of the net income of the estate as outlined above.

Remember, however, that any *residual* beneficiaries are not presently entitled to any income of the estate until such time that the estate is fully administered [IT 2622 paras 9 - 13].

Tax treatment of the lump sum death benefit

A lump sum death benefit paid to a deceased estate is taxed as follows:

- any tax free component is non-assessable non-exempt income (ie tax free) [ITAA 1997 s.302-10, ITAA 1997 s.302-140], and

- any taxable component is **included in the assessable income of the estate to the extent that a person who is not a death benefits dependant would reasonably be expected to benefit from the lump sum death benefit** [ITAA 1997 s.302-10]. The ordinary progressive marginal rates of tax will apply (as outlined above) to the relevant portion of the taxable component [ITAA 1997 s.302-145], however, a tax offset will apply [ITAA 1997 s.302-145] to reduce the maximum tax rate to:
  - 15% on the "taxed" element, and
  - 30% on the "untaxed" element.

Note that the **Medicare levy does not apply** to the taxable income of a deceased estate [ITAA 1936 s.251S].

Example 14

Gordon died in December 2018. In 2019/20 Gordon's estate received a lump sum death benefit of $1m from his superannuation fund.

The lump sum death benefit was comprised of:

- Tax free component: $300,000
- Taxable component (all taxed element): $700,000

Gordon's will bequeathed all of his estate to his 2 adult, financially independent children (Kylie and Brendan) in equal proportions. One of his children (Brendan) is not an Australian resident for tax purposes.

In 2019/20, Gordon's estate had other assessable income of $55,000 and deductions of $5,000.

The assessable income of Gordon's estate in 2019/20 would be $755,000 (ie $700,000 taxable component of the lump sum death benefit plus other assessable income of $55,000), and its taxable income would be $750,000 (ie $755,000 assessable income less $5,000 deductions).

Using the usual marginal tax rates, Gordon's estate would ordinarily pay tax of $310,597.

Gordon's estate would, however, be entitled to a tax offset of $197,800.00, calculated as outlined below:

Taxable income (including lump sum death benefit)	$750,000	Tax payable on taxable income (including lump sum death benefit)	$310,597.00
Taxable income (excluding lump sum death benefit)	$50,000	Tax payable on taxable income (excluding lump sum death benefit)	($7,797.00)
Prima facie tax payable on lump sum death benefit			**$302,800.00**
Maximum tax payable on lump sum death benefit ($700,000 x 15%)			($105,000.00)
Tax offset			$197,800.00

After allowing for the tax offset, Gordon's estate would have net tax payable of $112,797.00 (ie $310,597.00 - $197,800.00).

Once provision for this tax is made, and the administration of Gordon's estate is completed, his children would each have present entitlement to $468,601.50 (ie 50% x ($1m lump sum death benefit + $55,000 other income - $5,000 expenses - $112,797 tax payable)).

Note that:

- the tax rates applicable to Gordon's estate do not consider the residency status for tax purposes of the underlying beneficiaries of his estate – their tax residency status is completely irrelevant,
- the Medicare levy would not apply to the taxable income of Gordon's estate, and
- the estate distributions made to each of Gordon's children (ie $468,601.50) would not be included in their personal assessable income, and would therefore have no affect on any other "benefits" they may be eligible for (eg family tax benefit for the adult child who is an Australian resident for tax purposes) nor cause the imposition of any other costs (eg Division 293 tax on their concessional contributions to superannuation).

Comparing Kylie's "in the hand" death benefit to Brendan's, they have each receive the same amount.

Taxable income of underlying beneficiary is not affected by lump sum death benefit paid to the deceased's estate

As the taxable income of an underlying beneficiary is not affected by a lump sum death benefit paid to a deceased estate (remember, any taxable portion of a lump sum death benefit paid to a deceased estate is **always** assessed as income in the hands of the executor or administrator of the estate), the beneficiary will not be exposed to the loss of any "benefits" or incur any additional "costs" as their personal taxable income is unaffected.

Other considerations

While paying a lump sum death benefit to the deceased's estate will not affect the taxable income of the underlying beneficiary and may therefore be beneficial (as it would not result in the imposition of additional "costs" or loss of any "benefits"), it is important to remember, however, that each of the States and Territories has "succession legislation" that allows certain people (ie an "eligible person") to apply to the Supreme Court for:

- provision, or
- for *further* provision

from a deceased's estate (or **"notional estate**" in the case of NSW. In cases where the actual estate is not sufficient to meet a family provision order, the Court will consider whether the deceased has a "notional estate" – ie assets that did not belong directly to the deceased at the time of death, which can include superannuation accounts).

The rules vary amongst the States and Territories, as does the definition of "eligible person". In NSW, for example, an eligible person includes:

- the wife or husband of the deceased,
- a person who was living in a de facto relationship with the deceased (including same sex couples),
- a child of the deceased (including an adopted child),
- a former wife or husband of the deceased,
- a person who was, at any particular time, wholly (entirely) or partly dependent on the deceased, and who is a grandchild of the deceased or was at that particular time a member of the same household as the deceased, and

- a person with whom the deceased was living in a close personal relationship at the time of the deceased person's death (ie a relationship, other than a marriage or a de facto relationship, between two adult persons, who are living together, one or each of whom provides the other with domestic support and personal care).

Note that in NSW, stepchildren are not *automatically* eligible to apply for a family provision order, however, a stepchild may still bring an application if they meet certain criteria, ie they must demonstrate:

- they were, at any particular time, wholly or partly dependent on the deceased person (for instance, dependent on the deceased person for accommodation), and
- they were, at any particular time, a member of the household of which the deceased person was a member.

In QLD, for example, an eligible person includes:

- a spouse (including a husband/wife, de facto partner, civil partner or dependent former husband or wife or civil partner),
- a child of the deceased person (including a stepchild or adopted child), and
- a "dependent" of the deceased person. A "dependent" in this context means
    - a parent of the deceased person, or
    - the parent of a surviving minor child (ie under 18) of the deceased person, or
    - a minor person (ie under 18) who was being wholly or substantially maintained or supported by the deceased person at the time of the deceased person's death.

In VIC, for example, an eligible person includes:

- the spouse or domestic partner of the deceased at the time of death,
- a child of the deceased (including an adopted or stepchild or someone who believed the deceased to be their parent and was treated as such) who, at the time of death, was:
    - under 18,
    - a full-time student under the age of 25,
    - suffering from a disability,
- other children of the deceased not referred to above (eg adult children),
- a former spouse or domestic partner who was eligible to make a claim under the Family Law Act 1975 but either had not yet done so at the time of death, or such proceedings were not finalised and the claim cannot proceed after death,
- certain other individuals if they were dependent on the deceased for their proper maintenance and support, ie:
    - a registered caring partner,
    - grandchildren,
    - the spouse or domestic partner of a child (ie son or daughter-in-law) of the deceased where that child has died within one year of the deceased's death,
    - a person who was or had been (and was likely to be in the near future) a member of the deceased's household.

In each case, the Court will generally consider whether the deceased provided "adequate provision" for the applicant from the estate. If "adequate provision" was not been made, the Court will decide whether further provision should be made for the applicant, and if so, how much.