Superannuation death benefits: some discrete issues

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The authors' two-part article about discrete tax issues affecting deceased estates was published in this journal just as the pandemic descended upon the world. Although many things have changed since then, people's ability to ask tricky tax questions has not. This article considers some discrete issues relating to the taxation of lump sum superannuation death benefits. These include timing issues such as when the status of an individual as a dependant of a deceased member is determined, or when a determination should be made about which estate beneficiary is expected to benefit from a death benefit. Other issues considered are how to determine whether a beneficiary is benefitting from a death benefit or some other amount, and whether a beneficiary can benefit from an amount that is used to meet estate expenses.

Introduction

Superannuation death benefits do not automatically form part of a deceased estate. They will do so only when:

- a valid binding death benefit nomination (BDBN) is made by the deceased in favour of their legal personal representative (LPR); or
- the trustee of the superannuation fund (fund trustee) uses their discretion, or is otherwise obliged under the terms of the fund's trust deed, to pay the lump sum death benefit to the estate.

As fund trustees are only responsible for income tax withholding on death benefits if they pay them directly to beneficiaries, there appears to be a growing trend for industry funds to pay lump sum death benefits directly to a member's estate. This effectively transfers the responsibility for determining any tax obligations from the fund trustee to the LPR.

Death benefits: core concepts

Fund trustees are required to pay out a member's death benefits as soon as "practicable" after the member's death.[1] There is no definition or guidance in the *Superannuation Industry (Supervision) Act 1993* (Cth) or the *Income Tax Assessment Act 1997* (Cth) (ITAA97) as to precisely what this means; ultimately, it will depend on the facts of each case. As a matter of practice, fund trustees appear to adopt a six-month period as a rule of thumb.[2] While there is little evidence of the ATO questioning the time taken to make a payment, it should be remembered that a failure to satisfy the requirement could result in the fund being non-compliant.

When determining to whom a death benefit payment is paid, a fund trustee must ensure that they are authorised by both the trust deed and superannuation law to make the payment. Each trust deed is different, and it is essential that the trust deed be examined carefully.

If permitted by the deed, a member of a superannuation fund may elect to provide the trustee with specific instructions in advance of their death via a valid BDBN. On the member's death, the fund trustee would be obliged to operate in accordance with those directions. Some deeds provide that BDBNs lapse after three years, so it is necessary to refresh these on a regular basis to ensure that the member's intentions in respect of the payment of death benefits are met.

Where a member has left no valid BDBN, the fund trustee has the sole discretion to decide to whom the benefits are paid. A trustee is only able to make a payment to non-dependants after they have made reasonable enquiries to try and locate dependants or the deceased's LPR.[3] Accordingly, the non-existence of specific instructions may lead to a significant delay in the payment of benefits.

How tax is levied

The taxation of superannuation death benefits is governed by Div 302 ITAA97. As noted above, where a fund trustee pays a lump sum death benefit payment to an LPR, the responsibility to assess and pay any associated income tax will rest with the LPR.

Where an LPR receives a superannuation death benefit, it will be taxed in the estate as though it were income to which no beneficiary is presently entitled.[4] No further tax will be payable on a subsequent distribution to a beneficiary or to a testamentary trust.

The extent of an LPR's tax obligation is determined by reference to both the components of the deceased's superannuation account and the relationship to the deceased of the ultimate beneficiary/beneficiaries (that is, as a tax dependant or non-dependant of the deceased).

Where lump sum payments are to flow to a testamentary trust, it is necessary for the LPR to look through those entities to determine whether the ultimate beneficiary is a dependant of the deceased.

If the death benefit is expected to benefit a dependant, the entire receipt will be tax-free in the hands of the LPR, whereas an amount that is expected to benefit a non-dependant will be taxed as shown in Table 1.[5]

The maximum tax rates (15% or 30%) operate by way of a tax offset and the tax that would otherwise be payable on the taxable component of the benefit. The tax residency of

Table 1. Death benefit tax rates

Component	Dependant	Non-dependant
Taxable (taxed)	Tax-free	Lower of tax rate or 15%
Taxable (untaxed)	Tax-free	Lower of tax rate or 30%
Tax-free	Tax-free	Tax-free

either the LPR or the beneficiary does not alter the maximum tax rates.

Further, the fact that a non-dependant beneficiary is a charity does not mean that there is no tax payable by the LPR on the share that the charity is expected to benefit from.

Who is a dependant?

Table 2 summarises who is a death benefit dependant for tax purposes.[6] While this seems relatively straightforward, private rulings published on the ATO legal database highlight that identifying a death benefit dependant can be a complex process, particularly when reliance is placed on the interdependency relationship or financial dependence tests.

Interdependency relationship

Two people have an interdependency relationship[7] if:

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

Further, regulations may specify matters that are, or are not, to be taken into account when determining whether two persons have an interdependency relationship. Regulation 302-200.01 of the *Income Tax Assessment Regulation 1997* (Cth) provides that the following matters must be taken into account:

"(a) all of the circumstances of the relationship between the persons, including (where relevant):

(i) the duration of the relationship; and

(ii) whether or not a sexual relationship exists; and

(iii) the ownership, use and acquisition of property; and

(iv) the degree of mutual commitment to a shared life; and

(v) the care and support of children; and

(vi) the reputation and public aspects of the relationship; and

(vii) the degree of emotional support; and

(viii) the extent to which the relationship is one of mere convenience; and

(ix) any evidence suggesting that the parties intend the relationship to be permanent; and

(b) the existence of a statutory declaration signed by one of the persons to the effect that the person is, or (in the case of a statutory declaration made after the end of the relationship) was, in an interdependency relationship with the other person."

Table 2. Death benefit dependants for tax purposes

Relationship to the deceased	Tax dependant?
Spouse (including de facto and same sex)	Yes
Former spouse	Yes
Child under 18 (including ex-nuptial adopted and stepchild)	Yes
Child over 18 (financially independent)	No
In an interdependency relationship with deceased just before death	Yes
Financial dependant just before death	Yes

As explained in the explanatory statement[8] accompanying the regulation, it is not necessary for each of the listed circumstances to be satisfied in order for an interdependency relationship to exist. Each of the matters is to be given the appropriate weighting in the circumstances. There are also circumstances in which it would be inappropriate to consider certain matters.

Regulation 302-200.02 specifies when certain relationships will, or will not, be taken to be interdependency relationships, notwithstanding that certain of the usual requirements are not able to be satisfied because, for example, one of the parties is overseas or in gaol.

One issue that is problematic is the meaning of "close personal relationship" in the context of parent and child relationships. Generally speaking, it is not expected that children will be in an interdependency relationship with their parents because there is no mutual commitment to a shared life; the relationship between parents and their children would be expected to change significantly over time.

Financial dependant

Although s 302-195(1)(d) ITAA97 does not stipulate the nature or degree of dependency required, the test is one of financial dependence.

In *Malek and FCT*,[9] Senior Member Pascoe said:

"In my view, the relevant financial support is that required to maintain the person's normal standard of living and the question of fact to be answered is whether the alleged dependant was reliant on the regular continuous contribution of the person to maintain that standard."

Timing issue: dependence

Although the law states explicitly that the time for testing interdependency and financial dependence is just before the death of the relevant person, the position in respect of spouses and children relies on the ATO's practice. The ATO has indicated[10] that it will apply a similar timing rule for these categories of dependants. This means, for example, that a child who was under 18 when the deceased died will be regarded as a dependant, notwithstanding that they are older than 18 when the death benefit is paid to the LPR. Similarly, the ATO accepts that the payment of a death benefit to the estate of a spouse who was alive when the first deceased died is a payment to a dependant spouse.[11]

Timing issue: expected to benefit

A death benefit paid to the trustee of a deceased estate is treated as if it had been paid to a death benefit dependant to the extent that is has benefitted or is expected to benefit a dependant.

The ITAA97 does not specify a time when the test about "dependants benefitting or expecting to benefit" must be satisfied. However, given the reference in s 302-10(2)(b) ITAA97 to present entitlement[12] and the link to s 101A(3) of the *Income Tax Assessment Act 1936* (Cth) (ITAA36), implicitly the test must be satisfied at the latest by 30 June in the year in which the superannuation proceeds are paid to the trustee of the estate. Informal discussions with the ATO confirm this view.

Accordingly, the timing of the payment of death benefits to the trustee of an estate could be crucial where there is some prospect of a family provision claim being made. Such a claim can be made by a person for whom the deceased had a responsibility to provide. A person wishing to make a claim for provision must do so within strict time limits that vary in different states and territories. For example, in Victoria, this is generally within six months from the date probate was granted; in Queensland, it is generally within nine months from death.

Example

The deceased, Bradley, died on 1 April 2019. He was survived by two adult children and his (second) wife Beverley. By his will, Bradley left his entire estate to Beverley if she survived him, but otherwise it was to be divided equally between the children.

A superannuation death benefit in the amount of $200,000 was paid to the LPR on 28 June 2019.

As at 30 June 2019, no amount had actually been paid to Beverley but it might be argued that as at that date she would be expected to benefit from all of it (as having survived Bradley, she was the sole beneficiary of his estate).

However, the answer may be different if the benefit was paid to the estate in the 2020 income year, by which time a claim has been made for family provision. If that claim is not settled before the end of the income year, it is difficult to predict who may benefit from the payment. In these circumstances, it might be safest to assume that the payment will benefit a non-dependant (or a private ruling sought from the ATO).

People will often enter into a deed to settle a family provision claim in a year after the death benefit has been paid, which purportedly makes a dependant entitled to the death benefit. This does not seem to be effective for tax purposes in the earlier year.

Example

The deceased, Bradley, died on 1 August 2019. He was survived by two adult children and his (second) wife Beverley. By his will, Bradley left his entire estate to

Example (cont)

Beverley if she survived him, but otherwise it was to be divided equally between the children.

The children made a claim for family provision on 1 March 2020. A superannuation death benefit in the amount of $200,000 was paid to the LPR on 28 June 2020. On 31 July 2020, the parties entered into a deed of arrangement by which the parties agreed that Beverley would receive the death benefit.

Again, it is unclear who will benefit as at 30 June 2020. The deed which was entered into after the end of the year does not appear to be effective to alter the tax consequences in the 2020 income year.

Determining whether someone benefits from a death benefit or some other amount

Another issue that arises when applying s 302-10 ITAA97 is determining whether a person benefits from a death benefit as opposed to some other amount. A similar issue arises in a different context when applying s 99B ITAA36 (which exempts certain distributions of trust corpus). The latter provision was considered by the AAT in *Campbell and FCT*.[13] The tribunal found that the trust records were unreliable as evidence and consequently the taxpayer could not show that the relevant distributions fell within the corpus exception.

Example

Using the previous facts in the above example, assume that Bradley's daughter Bambi made a claim for family provision on 31 July 2019.

Assume also that the death benefit was paid to the LPR on 1 August and that the LPR was holding $200,000 from the sale of shares that Bradley had owned.

On 1 December 2019, all relevant parties entered into a deed, by which it was agreed that Bambi would receive $150,000. The LPR paid Bambi that amount on 10 December 2019.

The test time for s 302-10 purposes is 30 June 2020. It is important that the LPR be able to identify which money is used to satisfy Bambi's entitlement. If the LPR cannot show that Bambi's payment consists solely of the sale proceeds, some part of the payment made to her may be regarded as a payment of the death benefit. As Bambi is not a death benefit dependant, the LPR may well be subject to tax (depending on the components of the payment). If it can be shown that all of the death benefit was paid to Beverley, no tax would be payable (regardless of the components) as Beverley is a death benefit dependant.

For example, the LPR might consider keeping the death benefit payment in a separate bank account. Alternatively, if Bambi had been paid her entitlement before the death benefit was received by the trustee of the estate, it clearly could not have been a payment of that benefit.

What if death benefit is used to meet expenses?

In some cases, a death benefit is used to meet estate expenses. To the extent that an amount is paid to a creditor, is the death benefit regarded as benefitting a non-dependant?

Example

Poppy was killed in a workplace accident. She was 45 years old. Poppy left a will appointing her parents as her executors and her son Pablo as her sole beneficiary.

Poppy had substantial debts when she died. However, the trustee of her superannuation fund paid a death benefit of $400,000 to Poppy's executors. Some of this was used to pay Poppy's funeral and testamentary expenses and some was used to pay her debts. The balance ($200,000) was paid to Pablo. The executors obtained a ruling from the ATO that Pablo is a death benefit dependant of Poppy.

It was clear that the entire death benefit was never going to benefit Pablo. Does this mean that only part (50%) of it is tax-free on the basis that it is expected to benefit Pablo? And that the part (50%) that is used to pay creditors is to benefit a non-dependant?

When working out the tax payable by the trustee of deceased estate, s 302-10 draws a dichotomy between amounts that are expected to benefit "beneficiaries of the estate" who are dependants and those beneficiaries who are not.

For succession and, presumably, s 302-10 purposes, a creditor is not regarded as a beneficiary of an estate. This means in effect that s 302-10 can only ever apply by reference to the death benefit (net of expenses) that can benefit a beneficiary. It seems that the ATO agrees with this approach. In a private ruling,[14] the ATO indicated:

> "The fact that part of a superannuation death benefit may have been applied to pay outstanding liabilities of the deceased estate should not change the application of subsection 302-10(2) of the ITAA 1997."

This does not mean that, where a death benefit is expected to benefit a non-dependant, no tax is payable in respect of an amount used to pay creditors. Indeed, the ATO has taken the view in a private ruling that, even in an insolvent estate, tax is payable if the beneficiary who would have benefitted is a non-dependant.[15]

In specie asset transfer

Although death is considered a cashing event for a fund, the SISR94 contain no requirement that a death benefit lump sum must take the form of cash. This can be advantageous for SMSFs which hold real property.

There are, however, various matters that trustees and their advisers should consider before implementing an in specie transfer, including assuring themselves that the deed allows for such a transfer and whether there is enough cash in the fund to pay stamp duty and tax on any capital gain that might arise from the transfer.

Limitations of the SISR94

One issue that has not received much consideration in this regard is the operation of the SISR94. The regulations require that, in respect of each person to whom a benefit is cashed, it must be paid in either a single lump sum payment, or in the form of an interim lump sum payment and a final lump sum.[16] This means essentially that payments of lump sum death benefits are limited to two lump sum payments per recipient. This has been confirmed in informal discussions with the ATO.

This is problematic. Fund trustees following a member's direction to transfer particular assets or investments to a beneficiary (or their LPR) may be in breach of reg 6.21(2)(a) SISR94 (on the basis that each asset transfer amounts to a separate lump sum payment). On another view, it might be considered that a BDBN requiring that more than two assets be transferred to a person is invalid. This would mean that the transfer of those assets would have to be undertaken in accordance with the trust deed.

Again, while there does not appear to be any ATO activity in relation to this issue, trustees that undertake multiple transfers do so at the risk of receiving a qualified audit report for a breach of the SISR94 or making themselves potentially liable to a claim by those entitled under the deed in the absence of a valid BDBN.

A workaround that has been deployed in these situations is for a death benefit pension to be commenced before the assets are transferred. However, such a strategy is clearly limited to beneficiaries who are able to commence a pension as a result of the death of the deceased and by transfer balance caps.

Consideration might be given to amending the SISR94 to allow multiple lump sum payments where asset transfers are involved.

Conclusion

With superannuation balances in Australia now exceeding $2.9t, and the significantly escalating intergenerational wealth transfers occurring from Australia's ageing society, it is hardly surprising that superannuation is frequently one of the largest assets of many Australian deceased estates. This article has highlighted some of the timing and procedural issues that practitioners, when advising on estate planning and administration matters, need to be aware of in professional practice.

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References

1 Reg 6.21(1) of the *Superannuation Industry (Superannuation) Regulations 1994* (Cth) (SISR94).

2 M Heffron, *How quickly do death benefits need to be paid?*, 2 September 2019. Available at www.heffron.com.au/news/how-quickly-do-death-benefits-need-to-be-paid.

3 Reg 6.22 SISR94.

4 S 302-10 ITAA97.

5 S 302-10 ITAA97 interacts with ss 302-140 and 302-145 ITAA97.

6 The definition of "dependant" in s 302-195 ITAA97 differs slightly from the definition for superannuation purposes in that any child of the deceased is a superannuation dependant (the superannuation legislation essentially determines who can receive a benefit, while the tax legislation determines how that benefit will be taxed).

7 Defined in s 302-200 ITAA97.

8 Explanatory statement to the *Income Tax Amendment Regulations 2005 (No. 7)*.

9 [1999] AATA 678 at [10].

10 See TD 2013/12.

11 This was the position in TD 94/69 (now withdrawn) in respect of a predecessor provision and has been adopted in PBR 1051838730781.

12 Curiously, this provision appears to be incorrectly drafted. The current wording assumes that the payment is income (which it will not always be) and, even where it is, the provision will affect the way other amounts of net income are taxed. If the desired outcome is to tax the trustee, it may have been better for the provision to refer to the net income (rather than focus on entitlement to income). That is, the provision might have said that this part of the trust net income is assessable to the trustee, or following the introduction of the specific entitlement concept, say that the trustee is specifically entitled to the amount.

13 [2019] AATA 2043.

14 PBR 88506.

15 PBR 1011681715552.

16 Reg 6.21(2)(a) SISR94.

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