Technical Bulletin

Benefit Deductions

SuperGuardian

Self Managed Superannuation Funds (SMSFs) remain one of the most powerful retirement income and estate planning vehicles, even with the superannuation reform measures introduced from 1 July 2017.

With the abolishment of anti-detriment payments and the accompanying tax deduction from 1 July 2017, the purpose of this bulletin is to contemplate whether a Fund should consider claiming an alternative tax deduction, a deduction based on the future service portion of a benefit paid, available when a member dies or becomes disabled prior to age 65.

CHARTERED ACCOUNTANTS AUSTRALIA + NEW ZEALAND

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PAYING A DEATH BENEFIT IS INEVITABLE

Ideally when an individual dies, they will leave their tax dependants the benefit of what they have accumulated, knowing that as tax dependants they won't have to pay any upfront taxes. However, it is important to consider any additional tax consequences on the death of a member. Often the imposition of capital gains tax is overlooked, particularly for pension members where historically they may have had more money tied up in a tax exempt pension. Now they may have an accumulation interest, which may attract CGT.

Due to the tax friendly nature of superannuation, opportunities exist for monies to be recontributed or retained in the form of a pension minimising future tax liability for existing or new fund members. Of course sometimes it means paying tax upfront to save in the future. Timing can be critical here, especially for members nearing 60.

TRANSFER BALANCE CAP & ECPI

Prior to 1 July 2017 the most common death benefit strategy for a two member fund was for the surviving spouse to receive a pension from the deceased and to continue to receive a pension for themselves, if they were eligible. This maximised the tax effectiveness of the fund as the income on the assets was subject to the ECPI deduction.

The introduction of the transfer balance cap requires us to reconsider this strategy as an individual can have no more than the transfer balance cap (currently $1.6m) used to commence a pension. Therefore, in the instance where a member receives a death benefit pension from their spouse, their own pension may in some instances be commuted back to accumulation. When this occurs the fund will only be entitled to ECPI on the pension amount.

Now, more than ever, insurance will have a part to play in a) increasing a member's benefit and b) availing a fund to certain tax deductions.

DISABILITY TOO

These opportunities do not exist solely for Funds paying death benefits but potentially also for a Fund paying disability benefits.

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DEDUCTION AVAILABLE

Subdivision 295-G of the Income Tax Assessment Act 1997 (ITAA97) outlines the various deductions available relating to death and disability benefits. The focus of this bulletin will be Section 295-470 “Complying funds – deduction for future liability to pay benefits”.

FUTURE LIABILITY TO PAY BENEFITS

Section 295-465 of the ITAA97 allows a fund to claim a deduction for death and disability insurance premiums where the policy is held within the superannuation fund.

Alternatively, Section 295-470 allows a Fund to claim a deduction based on the future service portion of payment of:

a) a superannuation death benefit; or
b) a terminal illness benefit; or
c) a disability superannuation benefit; or
d) a temporary incapacity income stream.

Prior to claiming a deduction under 295-470 the Fund must make an election under 295-465(4) not to deduct amounts based on the premiums paid but rather to claim on the future liability to pay benefits.

ELECTION TO CLAIM FUTURE LIABILITY DEDUCTION

The election applies to all future years unless otherwise determined by the Commissioner of Taxation. Therefore, if a fund elects in the year of paying a benefit to claim for future liability and not for premiums paid it cannot in future years claim insurance premiums for other members of the Fund. The Fund can however claim the premium based deduction up to and including the year prior to the benefit being paid and make the election thereafter, effectively having premiums deductible in the first instance and then the benefit deductible.

This requirement makes the future liability deduction attractive to an SMSF as the deduction attributable to individual member premiums beyond the benefit payment will in many instances be less significant than the deduction calculated based on the benefit.

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TERMINATION OF EMPLOYMENT - DISABILITY QUIRK

The payment of a), b) or c) must be as a consequence of termination of a member's employment and is applicable whether a benefit is paid as a lump sum or taken as a pension. Prior to 1 July 2007 the deduction was only available for members who were employees however the legislation to simplify superannuation extended the deductions to the self-employed.

There will be a requirement to prove the link between the payment and the termination of a member's employment. Where the payment is linked to a disability benefit care will need to be taken to distinguish payments that are a result of ceasing work due to disability versus those that are paid due to someone being unlikely to be gainfully employed due to the disability. Previously the permanent incapacity requirement was determined based on an individual never again being able to work with the emphasis being that they were obviously employed in the first instance. The definition now excludes that element meaning someone does not need to have been employed but rather are unlikely to ever be employed due to their condition. This newer disability definition means someone who has never worked would not avail themselves of this deduction.

CALCULATING THE DEDUCTION

The formula for calculating the deductions is as follows:

Benefit amount x future service days/total service days

Benefit amount is the lump sum or the purchase price of the pension or the total of the amounts paid during the income year in the instance of a temporary incapacity income stream.

Future service days is the number of days from the date of termination to the members last retirement day (age 65).

Total service days is the sum of future service days plus the member's eligible service period to the day of termination.

Losses created by this deduction can be carried forward, this is the significance of the deduction for SMSFs as the deduction may not have a great impact in the year that it is claimed but may provide an ongoing benefit for the accumulation interests of the fund. Of course, with a deduction that provides the tax savings that this can, there are often drawbacks that need to be considered.

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UNTAXED ELEMENT OF A DEATH BENEFIT TO A NON-DEPENDANT

A superannuation death benefit paid to a non-dependant is taxable at 15% plus Medicare levy to the extent of the taxable component at the time of payment. If a deduction is claimed by a Fund under either section 295-465 or 295-470 an untaxed element must be calculated as per the formula below. The untaxed element will be taxed at 30% plus Medicare levy.

Amount of Superannuation lump sum x service days/service days + days to retirement

The taxed element in the Fund is the amount derived from the above calculation less any tax free component of the superannuation lump sum; the amount cannot be less than zero. If you subtract the taxed element from the taxable component of the benefit payment, the balance is the untaxed element. The superannuation lump sum will include any insurance proceeds. As can be deduced from the formula, the untaxed element is only applicable if the deceased was under 65.

CASE STUDY 1

FUTURE LIABILITY TO PAY BENEFITS DEDUCTION – DEATH BENEFIT

Assumption 1

Bill is aged 45 and has 18 years service period. He dies on his 45th birthday, he has a wife, a non-dependent 19 year old child and a superannuation fund balance of $500,000 comprising of $300,000 taxable and $200,000 tax free component, inclusive of insurance.

Bill's wife Belinda is self-employed and makes deductible contributions to their SMSF.

The Fund held insurance so elects to claim a deduction for the future liability to pay benefits.

Deduction is calculated as: **$500,000 x 20 years/38 years**
S295-470 Deduction **= $263,158**

The Fund had taxable income of $35,000 consisting of contributions, realised capital gains and other income.

In the first year the Fund creates a carried forward loss of $228,158 that can be offset against future contributions, gains and income. In this example the payment of $500,000 to Belinda is tax free as she is a dependent and as such no untaxed element calculation is required.

Benefit Deductions

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Assumption 2

As Bill's child, Ben, is over 18, let's look at the example in the event that Bill and his wife have previously separated. Ben, is now the other Trustee of the Fund having joined after his parents separated. In the year of Bill's death the Fund makes the election to claim the S295-470 deduction. The same amount is calculated as above, $263,158.

In addition to this, the death benefit payment to Ben, as a non-tax dependant, requires the calculation of the taxed and untaxed element:

Element taxed in the Fund	**$500,000 x 18 years/38 years**
Element taxed	**$236,842 - $200,000 (tax free)**
Element taxed	**$36,842 @ 15% + Medicare = $6,263**
Element Untaxed	**$300,000 (taxable component) – $36,842**
Element Untaxed	**$263,158 @ 32% = $84,210**
Total Tax on death benefit	**$90,473**

Bill's son will receive an after tax death benefit of $409,527 but will have the deduction of $263,158 to offset against the future income of the Fund. Remember that the SMSF was previously claiming the deduction on the insurance premiums so this calculation would have been required regardless.

The deduction is obviously more attractive for a death benefit payment to a dependant with a future tax liability inside of superannuation, however, non-dependants should not discount the value given the higher tax they may pay on earnings on death benefit proceeds outside of superannuation plus the potential tax on earnings inside the Fund.

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CASE STUDY 2

FUTURE LIABILITY TO PAY BENEFITS DEDUCTION – DISABILITY BENEFIT

As stated above, if a member meets the condition of release linked to permanent incapacity the trustee must be satisfied the member is unlikely to ever be gainfully employed. In the event of incapacity the member may be entitled not only to a tax deduction on the future service portion of the benefit payment but also be entitled to modify their tax free component of any lump sum. This was discussed in detail in our previous bulletin on benefit payments.

Tax free component of disability superannuation benefit plus future liability deduction

In our previous bulletin we used the example of Kate who ceased work due to incapacity. Let's revisit and revamp Kate's scenario now contemplating not only modifying a lump sum payment to her but including a deduction on the insured benefit for the fund.

As previously indicated, the tax free component of a disability lump sum benefit is calculated as the sum of the tax free component worked out under the normal proportioning rule and the amount worked out under the following formula:

Amount of benefit x Days to retirement
Service days + Days to retirement

Where:

- Days to retirement is the number of days from the day on which the member stopped being capable of being gainfully employed to his or her last retirement day, usually age 65.
- Service days are the number of days in the service period for the lump sum.

The taxable component is calculated by subtracting the total tax free component from the total amount of the superannuation benefit.

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Kate's Example
Kate's date of birth is 1 July 1971. Her employment commenced on 1 July 1996 and she stopped being capable of being gainfully employed on 3 September 2018. Her last retirement day would have been the day she turned 65, which is 1 July 2036. On 1 March 2019, Kate elected to receive a disability lump sum benefit of $400,000 from her superannuation fund. This represents the total value of Kate's superannuation interest including insurance. The superannuation interest includes a tax free component of $100,000 and a taxable component of $300,000.

STEP 1

Calculate the tax-free proportions of the superannuation interest just before the benefit is paid:

Tax free component	$100,000	= 25%
Value of the interest	$400,000	

Apply the proportion to calculate the tax free component of the lump sum benefit as if it was a normal lump sum benefit:

$400,000 x 25% = $100,000

STEP 2

Calculate the additional tax free component of the super benefit using the formula below:

Amount of benefit	x	Days to retirement
		Services days + Days to retirement

Where:

- Amount of the benefit is $400,000.
- Days to retirement is 6,512 days (from 3/9/2018 to 1/7/2036).
- Services days is 8,099 days (from 1/7/1996 to 3/9/2018).

The amount is therefore $178,276 ($400,000 x 6512/14611).

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STEP 3

Calculate the total tax free and taxable components of the disability superannuation benefit as follows:

The tax free component is the sum of the amounts worked out via Step 1 and Step 2:

$100,000 + $178,276 = $278,276

The taxable component is the remaining amount of the benefit:

$400,000 - $278,276 = $121,724

As Kate is under preservation age she will be liable for 20% tax plus Medicare on the taxable portion = $26,780

By satisfying the condition of "Disability Superannuation Benefit" the member has created the following tax saving:

Original Taxable Component = $300,000
Original Tax @ 22% = $66,000
Tax Saving = $39,220.

Future liability calculation

Now if we apply the future liability to pay a benefit deduction calculation, the fund will be entitled to a tax deduction as follows:

$400,000 x 6512/14611 = $178,276

Whilst this deduction can't be used to offset the tax on Kate's benefit payment it can be used to offset any CGT on the assets sold to fund the benefit. Similarly, if Kate makes a concessional contribution to help offset her personal tax liability the fund can use the deduction to offset the tax liability. Conceivably, subject to other income the fund generates, Kate could contribute $25,000 for a number of years without the fund having to pay any tax. Therefore, it is worthwhile looking at the overall taxation position not just the tax on the benefit payment.

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TERMINAL ILLNESS

Whilst the circumstances surrounding the deduction are not ideal it is worth noting that certain events make the deduction worth considering. For example, death with tax dependents is more appealing than death with non-dependents from a tax point of view and similarly it is more tax friendly than disability.

Terminal illness is perhaps the most tax advantageous of all benefit payments as the member is entitled to receive any lump sums without tax consideration and the fund will get the deduction on the full value of the benefit payment. This means that if a member has non-dependent children and is diagnosed with a terminal illness it may be worth contemplating taking the benefit as a terminal illness lump sum prior to death and thus avoiding the calculation of the untaxed element whilst still availing the fund of the deduction.

Whilst these conversations are not always the most palatable, it goes without saying that all clients are looking for legitimate options to reduce theirs and their family's tax liabilities so identifying this as an option in difficult times may provide alternative relief.

CONCLUSION

The introduction of the transfer balance cap means that the death or disablement of a member will not automatically result in a fund paying pension but may lead to more lump sums being paid, or more money being retained in accumulation, where possible.

Funds paying death or disability benefits to members/beneficiaries whilst continuing to generate a taxable income should consider the pro's and con's of claiming a future liability to pay benefits deduction subject to meeting the applicable conditions. Also, with the capacity to rollover death benefit pensions, there are now more opportunities than existed prior to 1 July 2017. For example a member's benefit could be paid out as a pension to the member's spouse, the fund could claim the deduction, the spouse could rollover the pension to another fund whilst retaining an accumulation interest in the SMSF to get the full benefit of the deduction. There are always many things to consider.