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TAX DEDUCTIONS FOR DEATH & DISABILITY

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Self Managed Superannuation Funds (SMSFs) are one of the most powerful retirement income and estate planning vehicles.

This bulletin reviews the commonly discussed strategy of paying an anti-detriment payment from a SMSF on the death of a member and contemplates whether a Fund should consider claiming a future service period deduction when a member dies or becomes disabled prior to age 65.

PAYING A DEATH BENEFIT IS INEVITABLE

“Nothing is certain but death and taxes” is quite possibly the most quoted proverb, particularly in the financial services industry but we shouldn’t resign ourselves to the fact that the act of one results in the other.

Ideally we will die leaving our tax dependants the benefit of what we have accumulated knowing that they won’t have to pay any upfront taxes but it is also important to consider future tax consequences .

Due to the current tax friendly nature of superannuation, opportunities exist for monies to be recontributed or retained in the form of a pension minimizing future tax liability of existing or new fund members.

DISABILITY TOO

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

DEDUCTIONS AVAILABLE

Subdivision 295-G of the Income Tax Assessment Act 1997 (ITAA97) outlines the various deductions available relating to death and disability benefits as well as the anti-detriment deduction. The focus of this bulletin will be Sections 295-470 “Complying funds – deduction for future liability to pay benefits” and 296-485 “Deductions for increased amount of superannuation lump sum death benefit”.

FUTURE LIABILITY TO PAY BENEFITS

Section 295-470 allows a Fund to claim a deduction on payment of:

- a) a superannuation death benefit; or
- b) a disability superannuation benefit or
- c) a temporary incapacity income stream.

The payment of a) or b) must be as a consequence of termination of a member’s employment. 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.

The formula for calculating the deductions as follows:

$$\text{Benefit amount} \quad \times \quad \frac{\text{Future service days}}{\text{Total service days}}$$

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 members eligible service period to the day of termination.

Losses created by this deduction can be carried forward.

ELECTION TO CLAIM FUTURE LIABILITY DEDUCTION

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. 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.

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 claim the premium based deduction up to the year the benefit is paid and make the election then.

This requirement makes the future liability deduction more attractive to a SMSF as the deduction attributable to individual member premiums will in most instances be less significant. Retail and Industry based Funds are less likely to claim this deduction due to the resulting loss of ability to claim annual premium deductions for all other members.

The Fund does not need to hold an insurance policy to be entitled to claim a deduction for future liability.

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 the taxed and untaxed element must be calculated as per the formula below. The untaxed element will be taxed at 30% plus Medicare levy.

$$\text{Amount of superannuation lump sum} \times \frac{\text{Service days}}{\text{Service days} + \text{days to retirement}}$$

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 can not be less than zero. The balance is the element untaxed.

The superannuation lump sum will include any insurance proceeds and anti-detriment payment.

CASE STUDY 1

FUTURE LIABILITY TO PAY BENEFITS DEDUCTION

Assumption 1

Bob is aged 45 and has 18 years service period behind him. He dies on his 45th birthday leaving a wife, a dependant child and a superannuation fund balance of \$500,000 comprising of \$300,000 taxable and \$200,000 tax free component.

Bob's wife Anna is self employed and makes deductible contributions to their SMSF.

The Fund holds no insurance so elects to claim a deduction for the future liability to pay benefits.

Deduction is calculated as:

$$\begin{array}{rcl} \$500,000 & \times & \frac{20 \text{ years}}{38 \text{ years}} \end{array}$$

S295-470 Deduction = \$263,158

The Fund had taxable income of \$35,000 consisting of contributions, realized 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 Anna is tax free as she is a dependant.

Assumption 2

Bob's child is over 18 and his wife has previously passed away. The son, who is the other Trustee of the Fund joins the Fund either prior to or after the death of his father. In the year of the father'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 the non-dependant son requires the calculation of the taxed and untaxed element:

Element taxed in the Fund =

$$\begin{array}{rcl} \$500,000 & \times & \frac{18 \text{ years}}{38 \text{ years}} \end{array}$$

Element taxed = \$236,842 - \$200,000 (tax free)

Element taxed = \$36,842 @ 16.5%

Element Untaxed = \$500,000 – 236,842

Element Untaxed = \$263,158 @ 31.5%

Total Tax on death benefit = \$88,974

CASE STUDY 1 (continued)

Bob's son will receive an after tax death benefit of \$411,026 but will have the deduction of \$263,158 to offset against the future income of the Fund.

The deduction is appears 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.

ANTI-DETRIMENT DEDUCTION

Section 295-485 provides a Fund with the ability to claim a deduction based on an increased amount of superannuation lump sum death benefit. This anti-detriment increased amount of death benefit is a result of the 1988 introduction of a mechanism to allow the Fund to claim the tax paid on contributions

This applies to any death benefit paid to a spouse, former spouse or child of the deceased member and ensures the payment to the recipient is the amount they could have expected to receive had no tax been paid on the contributions.

To be entitled to the deduction the Fund must first pay the increased death benefit. The Fund is entitled to a deduction calculated as follows:

$$\frac{\text{Tax saving amount}}{\text{Low tax component rate}}$$

The Tax saving amount is the amount by which the death benefit is increased.

The low tax component rate is the Fund's tax rate = 15%

The Tax saving amount must be certified by the Fund auditor as being the amount of benefit reduction due to the tax on taxable contributions. As very few funds have that information readily available for the Auditor to certify, the original explanatory memorandum provided an additional formula to calculate the tax saving amount. Whilst this formula can still be used, a subsequent formula has been released via ATO Interpretive Decision 2007/219. This subsequent formula results in an amount that is at least the equivalent or greater than the explanatory memorandum formula amount and is the basis of our examples.

The anti-detriment deduction is an additional deduction available to the Fund so it is possible for the Fund to claim the 295-470 and 295-485 deduction in the same year and create an extremely large carried forward loss for the Fund. **NOTE:** unlike the 295-470 deduction, anti-detriment can be claimed post age 65.

ANTI-DETRIMENT FORMULA

The formula to calculate the increase in the death benefit lump sum is as follows:

$$\frac{(0.15 \times P)}{(R - 0.15 \times P)} \times C$$

P = Number of days in R that occur after 30 June 1988

R = Total number of days in the service period post 30 June 1983

C = Taxable component of the lump sum (excluding any insurance proceeds having claimed 295-465 or 295-470 prior to the addition of the anti-detriment amount).

CASE STUDY 2

Based on the same information from the first case study, Bob dies and the Fund elects to pay an anti-detriment amount to Anne. Both R & P = 18 years as his start date was 1990.

Therefore based on the above calculation the increased death benefit would be:

$$(0.15 \times 18) / (18 - 0.15 \times 18) \times \$300,000 \quad (\$300,000 \text{ is the taxable component of his benefit})$$

$$2.7 / (18 - 2.7) \times \$300,000$$

$$\text{Increased death benefit} = \$53,941$$

The actual number of days is required for the purpose of calculating the final numbers.

$$\text{Total death benefit payable to Anne} = \$553,941$$

$$\text{Anti-detriment deduction} = \$53,941 / 15\%$$

$$\text{Anti detriment deduction} = \$359,606$$

Therefore Anne will receive a lump sum of \$553,941 and the Fund will be entitled to a deduction of \$359,606.

When added to the 295-470 deduction previously calculated it gives the Fund a total deduction of \$622,764 in the first year.

FUNDING AN ANTI-DETRIMENT PAYMENT

The greatest problem facing a fund wishing to pay an anti-detriment payment is that the claimable tax deduction is only allowed after the anti-detriment payment has been made. Therefore the Fund must have the ability to pay that amount in addition to the actual member balance.

This creates an issue for SMSF's as the Fund cannot reduce another member's entitlement to pay the increased death benefit.

Funds considering creating an anti-detriment reserve or insurance reserve must investigate whether the allocation from the reserve will create an amount to be counted against the deceased members concessional contribution cap.

Alternatively the fund may use excess cash (either via contribution or other means) to create a future income tax benefit asset ensuring no reduction in other members' benefits. This is a high risk strategy reliant on some form of longevity to reduce the future income tax benefit via tax refunds and could result in the Fund's inability to meet other liabilities post the death of the member.

It is recommended that the Trustees seek legal advice once they have calculated the potential benefit but prior to making the anti detriment payment

CONCLUSION

The extension of concessions to self-employed on 1 July 2007 has made available a number of alternatives that should be considered before paying a death benefit to a dependant or non-dependant, including whether insurance should be maintained inside a SMSF.

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. A fund shouldn't jump into anti-detriment strategy because it's the flavor of the month; it may be more viable for a member with multiple interests to transfer their taxable interest to a fund offering anti-detriment thereby avoiding the need to find extra money.

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