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Providing for future generations

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SMSF ASSOCIATION

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Providing for future generations

1. Overview

Superannuation provides for future generations. This can be via an SMSF or industry, retail or public sector superannuation fund. Indeed, superannuation is becoming an increasingly popular mechanism for providing for retirement, especially for those with SMSFs where the average fund balance is over $1m; for these people their super nest egg may well be their most valuable asset.

Naturally, there are a range of other methods of providing for future generations including:

- inheritance, ie, leaving assets via your will to your heirs, especially children and grandchildren;
- 'entities' such as trusts and companies, which can, broadly, result in transfers of assets outside of your estate. A discretionary trust is where a transfer of control of the 'appointor' role typically occurs. In contrast, shares are usually transferred or gifted in order to transfer the control of a company; and
- other means are available, eg, insurance and education bonds, etc, to provide for future generations.

We focus here on:

- super versus a range of trusts that obtain special tax treatment;
- tax concessions for minors at adult rates;
- effective tax planning, eg, income splitting if the children are adults;
- social security concessions;
- the strategic use of reserves and how best to leave reserves behind to the next generation; and
- why winding up an SMSF on the death of mum and dad may give rise to lost opportunities.

Likely establishment and ongoing administration costs of each option should be considered to ensure the chosen options is appropriate. You should consult with your accountant, lawyer and/or financial adviser to determine what the set up and ongoing management costs are.

Interspersed throughout, we will compare and contrast with superannuation, particularly SMSFs. A key aspect of this paper is to cover a range of strategies that advisers should be aware of when advising clients of their options.

2. Family discretionary trust

Unlike a company, a trust is not a separate legal entity. Rather, the word 'trust' describes a relationship. A trust arises where one person ('trustee') holds legal title to property for the benefit of another person ('beneficiary'). The trustee has obligations to maintain the property for the beneficiaries.

A discretionary trust is 'discretionary' as any distribution of income or capital to beneficiaries is made in the trustee's absolute discretion, and the potential beneficiaries are members of the same family and prescribed group, including eligible companies, trusts and charities. It follows that, generally, the beneficiaries have no enforceable interest in trust property — the beneficiaries merely have a right to ensure the trustee exercises its discretion in accordance with the provisions of the trust deed and otherwise complies with the deed.

Why a discretionary trust?

Some of the benefits of discretionary trusts include:

- greater flexibility in financial planning, including the capacity to distribute different types of income to different beneficiaries (ie, streaming net capital gains and franked distributions) in accordance with division 6E of the *Income Tax Assessment Act 1936* (Cth) ('ITAA 1936'). Thus, if you do intend to distribute a net capital gain or franked dividend (together with any attached franking credits) to a particular beneficiary, you can do so by ensuring the resolution makes the relevant beneficiaries specifically entitled to such amounts. Naturally, you should review the trust deed and the wording of any resolution to ensure it appropriately achieves the desired outcome. Otherwise, the general principle is that capital gains and franked dividends (and any attached franking credits) will broadly be distributed proportionately in accordance with the share of trust law income (refer to *FCT v Bamford* [2010] HCA 10);
- persons behind a trust can control the destination of income and capital;
- limited liability for a business (if a corporate trustee is used);
- flexibility in the manner of reward of family members in comparison to companies. If a family member is paid a wage many issues must be considered, such as PAYG tax, compulsory superannuation contributions, Workcover and pay-roll tax (note that NSW has special provisions for payroll tax where a notional wage can be imputed to assess payroll tax). These issues may give rise to liabilities that more than offset any deductions that can be claimed in respect of the payment of wages. However, making loans or capital distributions from the trust during a year of income and distributing profits at the end of each fiscal year can be an efficient alternative to these costly and onerous obligations (provided no fringe benefits tax arises);
- opportunities to distribute income to family members with lower marginal tax rates and to companies (companies currently pay 30% tax); and
- some simplification of succession planning (although wills need to be revisited).

Ordinarily, all taxable income earned by a trust (aside from a nominal amount) will be distributed to beneficiaries. A distribution can be paid, applied (ie, paid to another person on the beneficiary's behalf) or credited to an account maintained by the trustee to which the beneficiary is wholly entitled.

Adult resident beneficiaries include their share of the net income of a trust in their assessable income.

The position is more complicated if the distribution is to a minor beneficiary. Generally, the trustee incurs a primary liability to pay (ie, withhold) tax and the beneficiary is also obliged to pay the (secondary) tax. To that extent, the minor beneficiary is assessed for the secondary

tax and the beneficiary receives a credit for the primary tax levied against the trustee. Generally, the highest marginal tax rate is levied on minor beneficiaries (45% plus the Medicare levy and the Temporary Budget Repair Levy) except, in the case of resident minors, for a small threshold amount ($416 per financial year). Note, there are certain exceptions to the general taxation treatment of trust income derived by minors and these are discussed below with the special trusts covered in this paper.

The net income derived by a trust should generally be distributed by June 30 each year.

Generally, a discretionary trust distributes its net income to the beneficiaries who pay tax in respect of that income. Broadly, the income and capital in the Trust can be utilised for the education, maintenance and advancement of children, grandchildren, and other lineal descendants.

The 50% CGT discount under Division 115 of the *Income Tax Assessment Act 1997* (Cth) ('ITAA 1997') can be claimed by an individual beneficiary in respect of a capital gain distributed by a discretionary trust where the asset has been held for more than 12 months for the trust and is an asset on capital account (eg, the asset was not purchased with the intent for resale at a profit). Thus, where a 50% CGT discount applies to a net capital gain included in a trust distribution received by an individual beneficiary, that beneficiary will generally pay CGT on only 50% of the net capital gain received.

Note, however, that if a net capital gain is distributed to a company there is no 50% CGT discount available and the normal 30% tax rate applies to the entire capital gain.

Many overlook elementary tax planning where using a traditional discretionary trust may result in limited tax paid on investment income. For example, if there are two adult children then earnings on assets of around $728,000 being produced at a 5% yield would result in income of $36,400 each financial year. This amount split between two adult children would result in no tax as the amount per child is below the tax free threshold of $18,200 on which no tax is payable.

Note, however, for minors under 18 years, only $416 per financial year of passive income can be distributed without paying tax. This is why the special trusts discussed below can be more attractive as they obtain the ETI concession under div 6AA ITAA 1936.

Australian resident adult tax rates FY2015 (excluding levies)

Taxable income	Tax on this income
0 – $18,200	Nil
$18,201 – $37,000	19c for each $1 over $18,200
$37,001 – $80,000	$3,572 plus 32.5c for each $1 over $37,000
$80,001 – $180,000	$17,547 plus 37c for each $1 over $80,000
$180,001 and over	$54,547 plus 45c for each $1 over $180,000

3. Special disability trusts

A Special Disability Trust ('SDT') can provide children with a severe disability:

- certain social security/Centrelink advantages for the disabled child and certain family members who may be in receipt of social security benefits; and
- a trust structure that accesses adult tax rates and that will allow for income to be accumulated at adult tax rates. Note that typically the top marginal tax rate plus levies applies to income accumulated by a trust.

An SDT is designed to provide for the reasonable care and accommodation needs of a severely disabled child. To obtain concessional status, an SDT must comply with a range of rules, including:

- who can be trustee; and
- acquisitions from related persons are prohibited apart from acquisitions of listed securities.

An SDT will only be applicable if a child satisfies the social security 'severe disability' test in s 1209M of the *Social Security Act 1991* (Cth) ('SSA'). Broadly, this test requires an impairment that qualifies for:

- a disability support pension; or
- a carer payment/allowance; and

there is no likelihood of the child working for more than 7 hours a week for remuneration that exceeds the minimum wage.

Thus, if a child does not satisfy this 'disability' test, an SDT cannot be used for them.

Before establishing a an SDT, you should verify with Centrelink or Department of Veterans' Affairs (DVA) that the person for whom the trust is being established meets the definition of 'severe disability'.

Example 1:

> Assume Mary is 'permanently incapacitated' for superannuation purposes under regulation 1.03C of the *Superannuation Industry (Supervision) Regulations 1994* (Cth) ('SISR'). Mary's super balance would therefore be available for payment as a lump sum or a pension to her (ie, her balance would be unrestricted non-preserved).

Now, assume her family:

- wants to provide cash for Mary's future well-being; and
- are not fussed about social security benefits.

How much can be contributed to an SMSF for Mary?

> Say $180,000 for FY2015 and then 3 x $180,000 = $540,000. Thus, a total of $740,000 could be put into an SMSF to provide for Mary's future in a relatively short-time frame (assuming money is not limited).

If so, a sizeable account-based pension ('ABP') could be commenced for Mary from her SMSF. This would provide a very tax-effective income stream. This is because, under current rules, virtually no tax would be payable on such an income stream.

How much income tax would the SMSF pay on the pension assets?

Nil (100% in pension mode: s 295-385 and 295-390 of the ITAA 1997).

How much income tax would Mary pay?

Nil (100% non-taxable component: s 301-30 of the ITAA 1997).

The SMSF would therefore be very tax efficient (but would require at least a minimum pension payment each year of 4% of Mary's account balance). Thus, the minimum payment each year is required to ensure the pension exemption continues (in accordance with the ATO's position in TR 2013/5).

So, would an SDT be a better strategy given the attraction to an SMSF paying an ABP to a disabled child?

In summary, an SDT has two main benefits:

- Gifting concession of $500,000 for family, eg, if Mary' grandfather receives the age pension, he could gift $500,000 to the SDT without impacting his social security benefits. Usually, gifting of money or assets gives rise to 'deprivation' where only $30,000 can be gifted within a 5 year period without impacting social security benefits.
- There is also an assets test assessment exemption of $596,500 for the disabled child, Mary as indexed each year. Broadly, this means that Mary can own up to this limit without impacting her social security entitlements, eg, to say a disability pension.

Note, this paper is not intended to be an accurate description of the social security rules and is a broad summary only.

There are other potential benefits of SDT. As discussed above, an SDT is designed to provide accommodation benefits. Thus, an SDT can own a home for the disabled child. The benefits that may flow from an SDT owning the disabled child's home include:

- the CGT main residence exemption is available on Mary's home (typically, there is no exemption applicable to a dwelling owned by a trust); and
- an SDT can accumulate income at adult marginal tax rates ('unexpected income'). As discussed above, this is a significant advantage as trusts that accumulate usually do so at a 49% tax rate (including levies; 2% Medicare and the 2% Temporary Budget Repair Levy on individual's earning a taxable income above $180,000 for a fiscal year for FY2015 to FY2017). The income of the disabled child is effectively aggregated with that of the SDT and the applicable tax and levies are then determined.

In contrast, an SMSF must pay a pension each year to maintain the pension exemption.

In short:

- SDTs are great if social security is relevant and you want to buy home for a disabled person to live in; and
- SMSFs are great if you do not want to buy a home for a disabled person to live in and the said person is permanently incapacitated.

*Annexure A shows a disability flowchart to help decide whether an SDT is applicable. A good resource for further information on SDTs can be found at 'Special Disability Trusts Getting things sorted' available at https://www.dss.gov.au/our-responsibilities/disability-and-carers/publications-articles/special-disability-trusts-getting-things-sorted

4. Child maintenance trusts

As separation and divorce is a common occurrence these days, a child maintenance trust ('CMT') provides a planning opportunity to many who seek the benefit of putting assets on trust for the future benefit of their children. A CMT is specifically designed to ensure that income derived from property settled on such a trust is assessed at adult marginal tax rates.

Another way of describing the benefit of a CMT is that it is a method of reaching common ground between divorcing/separating spouses who are in a tug of war; with each spouse seeking a bigger share of the asset pool. A CMT can assist to minimise or neutralise such disputes by taking out the assets that both spouses would otherwise fight over. Placing assets on a CMT for the children can minimise a dispute between warring spouses (as they generally agree that the CMT assets are for the future benefit of the children).

The excepted trust income ('ETI') concession under div 6AA

Generally, the passive investment income of a trust that is distributed to children under 18 years of age will be taxed at the highest marginal rate; currently 47% plus levies for FY2015 under div 6AA of the *Income Assessment Act 1936* ('ITAA 1936'). However, if the income is 'excepted trust income' ('ETI') under div 6AA, then it will be taxed at the usual adult marginal tax rates plus levies. This point is relevant to the other trusts that we discuss below which we shall refer to as '*the ETI concession under div 6AA'*.

CMT — the ETI concession under div 6AA

The type of income which is ETI of a trust is outlined in s 102AG(2) of the ITAA 1936. In regards to a CMT under s 102AG(2)(c)(viii), amounts included in the assessable income of a trust estate will be ETI in relation to a child, if the amount is derived by the trustee from investing property that has been transferred to the trustee, for the benefit of a child/children as a result of a family breakdown.

There are added requirements that need to be satisfied under s 102AGA of the ITAA 1936. The transfer of property to the trustee for the benefit of a beneficiary (minor) will be the result of a family breakdown if the following conditions are satisfied:

- a person ceases to live with another person as the spouse of that person on a genuine domestic basis;
- at least one of the above is a parent of the minor beneficiary;

- an order, determination or assessment is made by a court, person or body because of the breakdown;
- an effect of the order, determination or assessment is that a person obtains a legal obligation to maintain and transfer property, etc, for the benefit of minors;
- property is transferred to the trust for the benefit of minor beneficiaries;
- this transfer takes place in order to give effect to or discharge the legal obligation; and
- the property ultimately vests in the minor beneficiaries when the trust is terminated.

As you will see from the above there are a number of criteria to be satisfied to ensure a CMT complies with relevant tax considerations.

The amount of assets that you intend to transfer to a CMT should be capable of producing the relevant income stream to provide the necessary support. Any amount that the Commissioner believes to be excessive will suffer tax of 49% (inclusive of levies).

If children are under 18 years of age, they will not be able to provide a legal discharge in respect of any income distributions that may be provided to them. However, a parent or guardian will be able to receive income on their behalf, provided it is utilised for their education, maintenance or advancement.

5. Superannuation proceeds trusts

There are two types of superannuation proceeds trusts ('SPT').

SPT not involving a deceased estate

The first is an SPT which is a trust designed to ensure that it falls within *the ETI concession under div 6AA* discussed above (so that the income of the trust is eligible for adult marginal tax rates).

In particular, an SPT is a trust that has property transferred to it on the death of a member of a superannuation fund. For example, if one or both parents die and leave minor children, the death benefit can be paid by the superannuation fund to the SPT trustee. This income is taxed adult marginal rates.

The ATO confirm in ATO ID 2001/751 (now withdrawn) that a superannuation payment paid to a trust, for a dependant who is an individual, was a death benefit for the purposes of the former provisions in the ITAA 1936. This ATO ID was withdrawn due to the introduction of the super reforms in July 2007 and due to changes in terminology and in the legislation (ie, the ITAA 1997) however it is still relevant in principle as the ATO confirmed a payment to a SPT was to a 'dependant' where the payment was:

> *If a superannuation payment is made to a trustee, it is an Eligible Termination Payment (ETP), however its 'death benefit' tax concession is generally lost. However, the … ATO … considers that a payment made direct to the trustee of a trust set up to benefit dependants of a deceased person will be death benefits.*

> *As the taxpayer has an absolute entitlement to the income, is the sole beneficiary and any income on death would form part of the dependant's estate, the payment to the trust is ultimately for the benefit of the dependant. The payment is a death benefit for the purposes of subsection 27AAA(4) of the ITAA 1936.*

This type of SPT is no longer that popular in practice but is still handy in certain circumstances. Recent situations where such a trust had been implemented involved a case of a surviving parent wanting to get some tax flexibility with having investments taxed at adult tax rates.

SPT involving a deceased estate

A will can include a separate trust to deal specifically with any superannuation which forms part of the estate (ie, a 'superannuation benefits trust' or a 'SB Trust').

Where a superannuation death benefit is paid to the legal personal representative ('LPR'), broadly, to the extent that beneficiaries who are 'death benefit dependants' ('DBD') (see s 302-195 ITAA 1997) benefit or, may be expected to benefit, from the super death benefit, the super is tax-free (s 302-10 ITAA 1997). Conversely, to the extent that beneficiaries who are not DBDs benefit, or may be expected to benefit under the estate, the taxable component of the superannuation death benefit is assessable to the trustee as if no beneficiary is presently entitled to such income: s302-10(2) ITAA 1997 and s 101A ITAA 1936.

Accordingly, as the SB Trust has a limited definition of beneficiaries (typically the client's spouse and children), it should be easier for the Commissioner of Taxation to come to a finding that DBDs should benefit from the superannuation and, therefore, treat this amount as tax-free.

Note that 'dependants' for superannuation purposes in s 10(1) of SISA includes adult children and some of these may not qualify as a DBD. This provides equality among children (and grandchildren should a child predecease – leaving children of their own). If the SB Trust beneficiaries was limited to DBDs, inequality among children (and possibly grandchildren) could arise unless the adult children were compensated in some other way, eg, by specific gift or by a greater share of the residuary estate. However, where the superannuation balance is a major asset of the client, equality may be difficult to achieve unless the client's affairs are regularly monitored. Where clients seek tax efficiency over equality among family members, and therefore limit the SB Trust beneficiaries to DBDs, they should be advised of this risk.

As an example, if Ben included an SB Trust in his will and this sub-trust was limited to DBDs, and if Ben had two children who were independent adults and two minors still leaving at home and $1 million in his SMSF and was not survived by a spouse, then the two minors would obtain $500,000 each and the two adults would receive nothing from Ben's superannuation benefit. If, however, the SB Trust beneficiaries was aligned to 'dependants' for superannuation purposes in s 10(1) of SISA, then each child would receive $250,000 each. However, the trustee of Ben's estate would incur some tax to the extent the benefit was paid to the adult independent children.

A testamentary trust will, with a broad range of beneficiaries, does not need to contain an SB Trust. In this case, all of the estate (including the superannuation paid to the estate but excluding any specific gifts which have been made) will typically fall into residuary estate and tax may be levied as a result of the application of s 302-10, as the Commissioner may not be satisfied that the super is destined to go into the hands of DBDs.

An SB Trust also offers some asset protection and income splitting advantages (although with a restricted class, these advantages are not that strong).

6. Estate proceeds trust

An 'estate proceeds trust' ('EPT') is a trust that broadly allows post-death planning for those that do not have testamentary trust wills. A testamentary trust will provides access to *the ETI concession under div 6AA*, as discussed above.

An EPT is specifically designed to satisfy the conditions in s 102AG(2)(d)(ii) of the ITAA 1936 to ensure the income from the trust's assets that is distributed to the children will be taxed at the adult marginal tax rates. For an EPT to qualify for the concession, the following conditions must be satisfied:

- property is transferred to the trust for the benefit of minor beneficiaries;
- the person transferring the property became entitled to it through a deceased estate;
- the transfer takes place within three years after the death of the person; and
- the property ultimately vests in the beneficiaries when the trust is terminated.

Example, Ben dies leaving his wife Mary and two children. Ben only had a simple will giving all his estate to Mary. Mary is already on the top marginal tax rate and is seeking to establish an EPT to reduce her tax burden. Mary has her lawyer prepare an EPT deed and transfers the amount of assets that would have gone to their children under the intestacy rules in respect of her husband's death. This assets are wisely invested to provide for the future education, maintenance and advancement of Mary's two children.

7. The strategic use of reserves for future generations

A reserve is an amount allocated to a separate reserve account in a superannuation fund (as opposed to a member's account). (We focus on investment reserves here and not on other types of reserves such as pension and contribution reserves.)

Unallocated reserves are maintained on behalf of the general fund and are not allocated for any member. Accordingly, they may be allocated at the discretion of the trustee, subject to the regulatory requirements and the governing rules. This is in contrast to a member's balance. More particularly, reg 5.04 of SISR provides that all of a member's benefits in the fund are that member's minimum benefits; which means the trustee must manage the minimum benefit for that member and can only pay the benefits to that member. Further, because they are the member's minimum benefits, such amounts must be cashed as a lump sum or pension on that member's death.

An amount allocated from a reserve to a member's account generally counts towards a member's concessional contributions ('CC') cap. An excess CC may give rise to assessable income to the member.

Establishing and maintaining reserves is likely to increase the administration (and administrative costs) of a fund, but can also offer significant advantages, eg, in the case of estate planning or investment smoothing whereby members' accounts may be supplemented with reserves during times of poor investment performance.

Section 115 of the *Superannuation Industry (Supervision) Act 1993* (Cth) ('SISA') permits the trustee of a superannuation fund to maintain reserves within the fund. However, this is subject to the fund's governing rules (the legislation expressly states that this law, which allows reserves, does not apply if the governing rules of the fund prohibit the maintenance of reserves). Thus, the fund's governing rules should provide sufficient powers and flexibility for effective reserving strategies. Some governing rules require that reserves must be allocated to each member's account on a proportionate basis and provide little or no discretion to the trustee. A review of the fund's reserving powers should therefore be undertaken before establishing any reserve.

Under SISA, the trustee of a fund is required to formulate and to give effect to a reserving strategy for the prudential management of any reserves maintained in the fund. The reserving strategy must be consistent with the fund's general investment strategy as well as its capacity to discharge its liabilities as and when they fall due. A reserving strategy must also be regularly reviewed (at least annually).

Note that this is a separate requirement to the requirement that all trustees formulate and give effect to a general investment strategy. It is therefore insufficient to rely on the fund's investment strategy for the maintenance of reserves.

A proper reserving strategy should demonstrate a consistent, long-term approach to maintaining reserves by the trustee with clear objectives. Typically, these objectives may be investment smoothing and to supplement member accounts and/or to provide for unforeseen future events, such as disablement or anti-detriment payments.

As a general guide, the level of a fund's reserves should not be greater than 15% of the fund's total balance. This has previously been accepted by the ATO as a reasonable level of reserves (see Superannuation Contributions Ruling SCR 1999/1). There is no upper limit prescribed by law. It is important, however, that the trustee comply with the 'sole purpose test' in s 62 of the SISA, which broadly requires that superannuation funds be maintained solely to provide superannuation benefits to members on retirement or to their dependants on their death. Excessive levels of reserves (especially if more than 50% of the member account balances) might evidence some other purpose and the potential inequity between members who finance a reserve and those who ultimately benefit from it becomes increasingly difficult to justify as the level of reserves increases.

The main issue with leaving reserves to future generations is who gets to control the fund as the controller will largely determine who gets what from reserves. Without a focus on who succeeds to control of an SMSF, disputes can easily arise whereby the stronger child/children may seek to gain control and utilise the reserves for themselves and cut out

their siblings or other family members. Thus, it is important that a smooth succession to control is planned to avoid such family bust-ups that can give rise to considerable legal costs and wastage. Refer to http://www.dbalawyers.com.au/smsf-deeds/smsf-succession-strategies/ for further information.

8. Why winding up an SMSF on the death of mum and dad may give rise to lost opportunities

An SMSF can continue on indefinitely. In contrast, a trust generally must vest within 80 years of its commencement. Thus, SMSFs provide a great vehicle for passing on assets to future generations.

Moreover, there may be considerable advantages that are associated with 'transferring' an SMSF on the death of mum and dad to the children and further down the family tree. These advantages may include:

- There may be particular assets such as business real property, grandfathered assets (eg, units in apre-1999 geared unit trust) or other difficult to replace assets which is best to 'keep in the family'. An SMSF may allow this provided the funding is right so the children may need to roll over balances and make sizeable contributions to pay out their parents death benefits. Moreover, there may be significant savings in what would otherwise give rise to significant transaction costs if the assets had to be sold and replacement assets sought and purchased.
- There may be economies with having more family members in the same SMSF. However, we generally recommend to introduce the children in as a matter of succession and not prior to that point to minimise any disputes. There are certain cases where introducing children earlier may be worthwhile.
- An anti-detriment deduction may give rise to a considerable tax deduction which can remain in the SMSF for future generations. The difficulty here is seeking to 'capture' an anti-detriment deduction which is difficult to do in an SMSF environment.
- Winding up an SMSF can itself prove a costly exercise. However, if there are some 'skeletons in the closet', it may be a good time to wind up the existing SMSF and start afresh in a clean skin SMSF.

9. Summary of different options

There are a range of different options to choose from when it comes to providing for future generations. Some options are for a specific purpose such as an SDT for a severely disabled child or a CMT for children of a divorcing/separating couple. There is also the opportunity of using a range of different options and this is where planning can make a significant difference in the long-run.

Annexure A