Super inheritances: The lump sum or pension conundrum

When an individual passes away it can be an emotional time for their family, but the decisions made when receiving a superannuation death benefit can have significant tax implications long term.

There are several options available to a dependant beneficiary when receiving a superannuation death benefit. This article explores the potential tax outcomes of each option.

Case study

At the age of 60, Richie passed away. Richie had a life insurance policy in an insurance-only superannuation master trust. To remove any uncertainty around his estate, Richie had a binding nomination in favour of his wife, Sue (aged 57). Sue now has two options to choose from: (1) to take the benefit as a lump sum into her personal name or (2) commence a death benefit pension with the proceeds.

Scenario one: taking a lump sum

Sue elects for the insurance-only fund's trustee to pay the death benefit into her personal bank account. Ideally, Sue wants the proceeds invested in a tax-friendly structure because her existing investments, together with her employment income, has placed her in the second-highest tax bracket.

Contributing proceeds: from bank account to superannuation

As a result of Sue electing for the death benefit lump sum to go into her bank account, she then considers whether she can contribute this amount into her personal super fund. From a technical perspective:

- Sue can contribute up to $300,000 using the non-concessional bring-forward provision depending on her balance and whether she has utilised this option in the previous years.
- If Sue's balance exceeds $1,600,000 or starts approaching this balance cap limit, she may not be eligible to utilise the full bring-forward provisions or may even be prevented from making any non-concessional contributions.
- If Sue is eligible to make contributions, the contributed amount will be preserved (i.e. locked away) until she meets a condition of release (e.g. ceasing employment after her 60th birthday or attaining age 65).
- Assuming Sue utilises the full bring-forward provision, contributing $300,000 as a non-concessional contribution she will be left with $700,000 remaining in her bank account until the three-year bring-forward period elapses, with any earnings accruing during this time assessed at her marginal tax rate.

Could Sue have rolled over the lump sum death benefit directly into her accumulation super fund instead of having it paid into her bank account?

The short answer is no because the taxation and super laws only permit Richie's death benefit to be paid to Sue as either a lump sum or pension. In other words, a death benefit cannot be rolled over into the beneficiary's own personal super fund or to be held in accumulation phase.

Although Sue cannot commence a pension within the insurance-only fund that holds the life insurance proceeds, she may rollover the death benefit to commence a death benefit income stream with a provider who can facilitate a superannuation pension. This income stream could be with her existing superannuation provider but must be kept separate from her personal retirement savings. The amount must remain in the retirement (pension) phase of super, or may be commuted to a lump sum death benefit if requested by Sue at a later date.

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Alternative investment structures

If Sue is not eligible to make contributions to her super or if she does not wish to contribute, she could look at alternative tax-effective structures to house the proceeds, such as a:

- Family trust
- Testamentary trust
- Superannuation proceeds trust (in absence of provision for a testamentary trust), or
- Investment bond

Please note, some of these options require planning and arrangement prior to the claim event such as provision in the individual's will to establish a testamentary trust upon death.

Sue will need to consider the characteristics of each structure and decide which is appropriate for her circumstances.

Scenario two: commencing a death benefit pension

Sue could rollover the proceeds to commence a death benefit pension instead of cashing out the death benefits into her bank account. Please note that this option is only available for qualifying dependant beneficiaries as defined under super law (generally a spouse, children under 18 or other financially dependent individuals).

Effect of transfer balance cap

Since 1 July 2017, the maximum amount that can be transferred to the retirement phase of superannuation is limited by the transfer balance cap ($1,600,000 for 2017/18). Death benefit pensions are generally bound by standard pension rules but with an additional restriction that prevents capital from being commuted back to accumulation phase. This means that death benefit pensions are not exempt from the transfer balance cap[1] and any funds in excess must be taken as a lump sum. The purchase price of the death benefit pension will be counted as a credit towards the recipient's transfer balance cap, as opposed to an automatic reversionary pension, where the credit occurs 12 months from the date of the original member's death.

1 There are modifications to the transfer balance cap for children in receipt of a death benefit pension.

In Sue's situation, her ability to commence a death benefit pension and the amount which can be taken as a pension, hinges on her available transfer balance account.

For the purposes of this case study, we assume Sue previously commenced a pension during 2017/18 with $900,000, leaving $700,000 available in her $1,600,000 transfer balance account. Let's explore Sue's two options.

Option one – partial death benefit income stream / partial cash out

Sue could:

- commence a $700,000 death benefit pension using her available transfer balance account, and
- cash the remaining lump sum death benefit into her bank account.

Commencing a death benefit pension with Sue's available transfer balance account will ensure $700,000 of the death benefit is invested in a tax-free environment. This is opposed to the capital accruing outside of super where earnings would be assessable at her marginal tax rate of 39%[2].

Sue may wish to re-contribute the cashed out lump sum into super, however she may incur the issues outlined above. More specifically for this example, Sue would not be eligible to contribute these additional non-concessional contributions because her total superannuation balance exceeds $1,600,000.

Option two – partial commutation of existing pension/ full death benefit income stream

Sue could:

- roll back $300,000 of her existing pension into accumulation phase, resulting in a $300,000 debit to her transfer balance account, and
- commence a $1,000,000 death benefit pension using the life insurance proceeds.

  Commuting a portion of Sue's existing income stream increases the money retained in the superannuation system by allowing her to commence a death benefit income stream with all the life insurance proceeds. Therefore Sue would not be forced to take any portion

2 2017/18 financial year; includes 2% Medicare levy.

as a lump sum. While $300,000 will be invested in the superannuation accumulation phase, earnings will be assessable at a maximum rate of 15%, as opposed to her marginal tax rate of 39% which was discussed in Option One above.

Key takeout: Advice implications for Priority Protection Superannuation Life Cover

When recommending superannuation life cover, ensure that the chosen ownership vehicle (i.e. insurance-only master trust, SMSF or platform partner super fund), aligns with the estate planning objectives of the client.

What are the benefits of Sue opting for a pension?

Pros	Cons
The insurance proceeds may be retained in super and invested within a **tax-free/concessionally taxed environment** without invoking her non-concessional contributions cap.	There could be future superannuation and related taxation **legislative risk** when retaining the proceeds within the super environment.
Pension payments are tax-free (since Richie had turned 60).	The costs associated with ongoing investment via a super fund.
On Sue's death, any balance remaining in her super fund account(s) could be paid directly to her children, keeping the proceeds outside of her estate.	Erodes transfer balance account.
Sue retains ongoing full access to the capital and can withdrawal lump sums in the future.	Death benefit pensions are bound by minimum pension payments thereby forcing money out of the superannuation environment each year.
Superannuation, as an investment vehicle, provides Sue with a degree of **asset protection** from any subsequent bankruptcy/ relationship breakdown.	

Final observation

Any recommendation for superannuation life cover should always be made with consideration to the estate planning objectives of the life insured and their intended beneficiary(s).

From a surviving spouse's perspective, the ability to retain a death benefit within the super environment offers considerable appeal. Logistically however, this can generally only be achieved by electing for a pension.

It's therefore critical that:

- the appropriate nomination of beneficiary forms are in place
- the recommended super fund ownership structure facilitates the payment of death benefits to the eligible dependants in the form of a pension or provides the option to rollover to a fund that does (where the pension option is desired by the client).

Otherwise, superannuation contributions, balance caps and work test constraints (for a surviving spouse over 65) could result in significant capital sitting outside of super, leading to potential taxation and/or asset protection inefficiencies.

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