Most estate planning for tax is inadequate

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Matthew Collins August 28, 2018

Over the next 20 years, there will be an intergenerational transfer of wealth the likes of which has never been seen before. Wealthy baby boomer parents will die leaving their estates, in most cases, to their children. Most will also leave income tax liabilities.

When they receive their inheritance, the children will have two main tax issues to deal with:

- Minimising tax payable on the benefit (eg. tax payable by the estate) and
- Finding an investment structure to hold assets that allows for future tax minimisation.

Through proper management and planning, the 'after-tax' value of the inheritance can be greatly improved. Despite this, many wealthy individuals have a will that does not deal with the tax consequences of their death adequately.

What can be done within a will?

A will provides excellent opportunities for tax planning. Generally, under a will, assets can be transferred to a new investment structure without the usual impost of stamp duty or capital gains tax. The ownership of assets can be rearranged to provide a better tax result.

A will also allows for the establishment of a 'testamentary trust'. In broad terms, assets can be inherited by a beneficiary but held via a trust which they control. The beneficiary can generally then direct income from the trust to pay various family members in a tax-effective way. Family members receiving distributions may include children under the age of 18. Family trusts, set up while a person is alive, cannot distribute to children under 18 without the beneficiary being taxed at the top marginal tax rate.

Management of tax payable by the estate

In most cases, the assets of the deceased are liquidated and the funds distributed to the various beneficiaries. This can result in two major tax consequences:

- Capital gains tax on the disposal of the deceased's assets
- Death benefit tax on superannuation withdrawals.

Proper planning may reduce or eliminate these taxes.

1. Capital gains tax

In basic terms, a testamentary trust can provide flexibility to those who receive taxable income resulting from the sale of estate assets.

I recently had a client die while holding two properties. One was his home, which is exempt from capital gains tax. The other was a 'weekender' which had grown in value by $400,000 since it was purchased. He had four children, who each had personal taxable income over $100,000, and 12 grandchildren, all under 18-years-old.

Before the property was sold, it was transferred, under the will, to four testamentary trusts, one for each beneficiary. This allowed for the capital gain to be split between the grandchildren. As a result, no tax was paid.

2. Superannuation death benefit tax

A common scenario is where the last parent dies and leaves superannuation to their adult, non-dependant, children.

Adult non-dependant children will be required to withdraw money from superannuation. They have no choice. This will usually result in tax of 17% being payable on the withdrawal of the 'taxed' portion of superannuation. If the member's balance is large, this can amount to many hundreds of thousands of dollars in tax.

So, what can be done?

The simplest way to avoid death benefits tax is for the superannuation to be withdrawn before death. The assets are then held in the member's personal name instead of being held in the superannuation fund. A withdrawal by a member, over 65, and in some cases earlier, is not subject to tax.

The obvious problem with this strategy is we don't know when we are going to die. However, often we have some idea, and if reducing income tax payable is important to the member, then steps can be taken.

In a simple scenario, a member with a terminal illness can withdraw their superannuation themselves. However, individuals are often not able to make such decisions once their health has deteriorated. An alternative is for a power of attorney to be provided with the authority to make the withdrawal. In my experience using an attorney can work, but only if the following takes place:

- The member gives clear instructions to the power of attorney before their health deteriorates, and
- The process is explained to the other family members.

It always needs to be remembered that the attorney owes a fiduciary duty to act in the best interest of the member.

There are a number of strategies that can be used to make a speedy withdrawal, but these are outside the scope of this article. Suffice to say that, where the tax liability is reasonably high, it may be worth considering as part of a tax effective estate plan.

Strategies to minimise future income tax payable by beneficiaries

In recent years, it has become increasingly difficult to invest in a tax-effective way. Changes to superannuation place limits on the ability to reduce income tax. Labor policy includes additional measures such as the removal of negative gearing and the taxing of trusts at a rate of 30%.

There is every likelihood that future beneficiaries may receive an inheritance in an environment where:

- After-tax superannuation contributions are limited to $100,000 per year or less
- A person can no longer make after-tax superannuation contributions once their balance reaches $1,600,000.

Two strategies could be considered:

1. Holding investments long term via a testamentary trust

For many years, families have used discretionary trusts (also known as family trusts) to hold investments and distribute income to family members with little or no taxable income. Labor intends to stop this. Their proposed policy can be found in a fact sheet titled "A Fairer Tax System – Discretionary Trust Reform". On page 10, it states that the policy will not apply to testamentary trusts. If legislation is eventually introduced, and this exemption remains, testamentary trusts may become a useful structure for holding investments for the long term.

2. Lending to adult children so they can make contributions

I expect the following scenario becoming common in the future:

- Children not having available funds to make superannuation contributions during their working life
- When they are older, perhaps in their 60's, receiving a sizable inheritance
- Only being able to transfer a small portion to superannuation due to contribution restrictions.

In selected circumstances, the following strategy may be useful:

- Parents lend money to their adult children
- The children make a contribution to superannuation
- The loan is 'paid back' out of the estate on the death of the parents.

If implemented correctly, this strategy may result in additional funds ending up in the beneficiaries superannuation accounts. However, there is a lot to consider before implementing a strategy like this and professional advice should be sought.

Conclusion

The purpose of this article is not to provide an exhaustive list of potential strategies or to analyse any particular strategy in depth. Instead it is to alert readers that there are opportunities available and to encourage you to seek advice sooner rather than later. I have found that many people are uncomfortable speaking about estate and death issues. I understand this. However, a well thought out and considered estate plan can not only result in significant tax savings but also provide for greater family harmony.

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