eureka
report

Death Without Taxes?

Theo Marinis shares strategies to help charities, family members and friends inheriting an estate invested in super reap the proceeds in the most tax effective way.

By Theo Marinis

9 Aug 2022

Most Australians assume death taxes are an anomaly from the past, but for the estates of superannuation fund members, they are alive and kicking. The innocuously named ‘Death Benefits Tax’ (DBT) pours tens of millions into ATO coffers annually.

At 17 per cent, DBT is currently levied on any ‘taxable component’ super benefit lump sum not consumed by its original owner or their financial dependents. Consequently, a million-dollar superannuation inheritance to, say, a financially independent adult daughter could be reduced by a payment of $170,000 to the ATO. The tax argument is that the money was treated concessionally while it was accumulated so a contribution on the windfall to government coffers is reasonable.

Recently, I had the opportunity to consider the situations of two clients, each single medical professionals in their 60s, who have had the good fortune to accumulate sizable retirement savings as well as property and other investment assets held outside of superannuation. Understandably, neither are fans of paying unnecessary taxes, and both wish to protect their estates so that the charities, family members and friends who inherit the proceeds from their respective estates receive the maximum return possible.

These considerations prompted me to revisit the potential for tax saving provided by Insurance Bonds, a topic about which I have written in some detail in the past. Also known as Investment Bonds, Insurance Bonds attract little media attention so few investors realise that they do not attract DBT.

For the purpose of this exercise, our case study was based on the details of one of the clients, who continues to work part time, teaching surgery. His total super balance is currently $2.7 million ($1.7 million of which is in tax-exempt pension phase, courtesy of the Transfer Balance Cap rules which limit the balance which can be moved to pension phase) with the remaining $1 million is in accumulation phase. He also has considerable assets and income outside of the super environment.

No tax is paid on the funds in pension phase, as he has achieved his preservation age and met a Condition of Release. The earnings on the $1 million in accumulation phase attract tax at 15 per cent and this is still considerably better than his personal tax rate of 47 per cent.

If he had a spouse, he could, in time, transfer the balance of his super in accumulation phase to his partner's pension account (assuming the partner does not also have Transfer Balance Cap issues) and pay no tax on the entire $2.7 million.

But he does not have a spouse. So, one strategy may be to consider the mix of investments by "tilting" the more aggressive and higher return portfolio component toward the pension fund, which attracts no tax, and structuring the passive, more secure component of the portfolio in a direct investment held externally to the superannuation taxation environment. Theoretically, this strategy will supercharge returns and mean that very little tax is due.

The appropriateness of this strategy depends on the individual's personal tax rate at retirement and would only be an option if the only investments in the equation are currently held as superannuation assets.

However, this does not apply to the individual in our case study, who will continue to have significant taxable investment income at retirement. Therefore, the alternative strategy was to examine what would happen if his $1 million in superannuation accumulation phase (taxed at 15 per cent on earnings and subject to 17 per cent DBT) was cashed out and replaced with an Insurance Bond.

The outcome was that, during the first 19 years, an investor using this strategy would have the potential to enhance the tax effectiveness of their estate, even though Insurance Bond earnings are taxed at 30 per cent versus 15 per cent tax on earnings in super.

The strategy could see a net estate benefit of approximately $169,000 in year 1, reducing to approximately $20,000 in net savings by year 18.

The anomaly is because DBT is not levied on the payment of Insurance Bond proceeds to an estate, compared with DBT of 17 per cent on the lump sum payment of superannuation benefit proceeds. Under current rules, once your Insurance Bond has been acquired, the ATO can no longer claim a slice of that part of your estate, leaving you with the potential to leave a higher amount for your beneficiaries.

Why 19 years? After that time, and based on the assumptions used, the additional net earnings within super (given the lower internal tax rate of super versus the Insurance Bond) will see the net super benefit exceed the lower Insurance Bond benefit, despite the Insurance Bond being tax free to the estate, versus the 17 per cent tax on the super lump sum.

Bearing in mind that no one lives forever, the trick here is to work out when a decision to look at an Insurance Bond should be considered. It may be age 85, on diagnosis of a terminal health condition, or when you no longer have financial dependents. For the broader majority, staying invested in the super environment will continue to be the most tax effective decision.

Ultimately, the purpose of this experiment is to demonstrate that it is not easy to do it yourself; in fact, this particular strategy is only now being considered due to the Transfer Balance Cap rule changes in 2017. Had these changes not occurred, you would simply keep the entire $2.7 Million in a Tax-Exempt ABP.

Case study assumptions:

- $1m Super balance in excess of the TBC of $1.7m already in a Tax-Exempt ABP.
- 'Like for Like' portfolios with the same earnings and capital gains in super and Insurance Bond but with allowance for different internal tax rates and the DBT rates.

- The Taxable component of the super balance is 100 per cent, therefore the Taxable Component will not change with earnings growth.
- Minimal to no initial and ongoing CGT based on a portfolio using 100 per cent Index Investment solutions (versus actively traded investments in both super and Insurance Bond portfolios).
- Personal SAPTO threshold has been fully utilised.
- Investment companies/trusts/larger CGT exempt home have been considered and are not suitable or available.
- Gradual gifting of the excess TBC amount in super as pre-inheritance payments to dependants (within sensible limits) has been considered and disregarded.

Every situation is unique, and individual circumstance will determine the best option for you at different phases of your life. This is just one strategy which could provide the potential to reduce the impact of one of life's certainties – taxes. I recommend you consult your doctor about the other.

Theo Marinis is Managing Director of Marinis Financial Group.

Disclaimer: Performance data quoted represents past performance and does not guarantee future results. The information in this article is general information only.It is not intended as financial advice and should not be relied upon as such. The information is not, nor is intended to be comprehensive or a substitute for professional advice on specific circumstances. Before making any decision in respect to a financial product, you should seek advice from an appropriately qualified professional on whether the information is appropriate for your particularneeds, financial situation and investment objectives. The information provided is correct at the time of its creation and may not be up to date; please contact Marinis Financial Group for the most up to date information.

Proudly

INVESTSMART

Financial Strategies (SA) Pty Ltd trading as Marinis Financial Group
T 08 8130 5130 | **F** 08 8331 9161 | **A** 49 Beulah Road, NORWOOD SA 5067
E admin@marinisgroup.com.au | **W** marinisgroup.com.au
ABN 54 083 005 930 5067 | **AFSL No:** 326403