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Death without Taxes?

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.

DBT at the rate of 17% is currently levied on any 'taxable component' super benefit lump sum, not consumed by its original owner, or their financial dependants. 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 have had the opportunity to consider the situations of two (completely unrelated) 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 will 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 a previous issue of the Eureka Report. This time, the purpose was to examine a different and quite distinct proposition, namely – the tax (DBT) effectiveness of Insurance Bonds versus funds invested in the superannuation environment.

It is also appropriate to point out here, that Insurance Bonds (also known as Investment Bonds) are generally not well understood and attract little media attention; therefore, few realise that they do not attract DBT.

The scenario used in our modelling received detailed technical analysis and input; it relied on a number of assumptions which are detailed below. The outcome did not deliver a 'one size fits all' solution, but the discussion around it demonstrates that the value in getting good advice means having the ability to consider alternative strategies, even if they are eventually discounted, or not recommended in a particular situation.

For the purpose of this exercise, our case study was based on the details of one of the aforementioned clients, who continues to work part time, teaching surgery. His total super balance is currently $2.7m ($1.7m 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 $1m 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 a met a Condition of Release. The earnings on the $1m in accumulation phase attract tax at 15% – and this is still considerably better than his personal tax rate of 47%.

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 TBC issues) and pay nil tax on the entire $2.7 million dollars. As he does not have a spouse, the vanilla approach may well be to say, "Well done, you have the best strategy available to you, and the amount you are paying in tax on $2.7m in retirement savings is reasonable for an investment of that size".

For most people, that could be an appropriate conclusion.

On the basis that near enough is never good enough, however, the ability to find and evaluate other options might need some thinking outside the square.

Another strategy may well be to consider the mix of investments (based on the client's investment appetite determined by their risk profile) 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 the engine of 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.

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 $1m in superannuation accumulation phase (taxed at 15% on earnings and subject to 17% 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%, versus 15% tax on earnings in super.

Based on the assumptions detailed below, 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 Death Benefits Tax (DBT) is not levied on the payment of Insurance Bond proceeds to an estate, versus DBT of 17% 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, 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% 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 thought 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.

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.

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%, therefore the Taxable Component will not change with earnings growth.

- Minimal to no initial and ongoing CGT based on a portfolio using 100% 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.

**refer 'Cashing In on Insurance Bonds' – Eureka, June 2017*.
^refer 'A Super House Strategy' – Eureka, August 2018

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