Tax-effective estate planning

Many parents take out life insurance so that in the unfortunate event of their death, their children are provided for. But parents often fail to consider how their children will actually receive the insurance proceeds. A lack of thorough estate planning can lead to a less than optimal result.

Let's take a look at a case study demonstrating the importance of tax-effective estate planning strategies.

Case study

Melissa and John are married and have two sons: Hamish (age seven) and Luca (age five). Melissa and John both have life insurance through superannuation.

Melissa is diagnosed with a brain aneurism and passes away within two months of the diagnosis. Her superannuation fund, in accordance with her binding nomination, pays the benefit to John.

Once John receives the money, he repays the mortgage and invests the remainder. John earns $200,000 per annum and this means he pays tax on the investment earnings at his marginal tax rate of 46.5 per cent.

If John subsequently transfers the funds into the children's names, the outcome is also not tax effective. All the income earned by Hamish and Luca would be subject to penalty tax rates and the low-income tax offset (LITO) would not apply.

Unearned income of minors in the financial year	Tax rate
Up to $416	Nil
$417 - $1,307	$0 plus 66% on the excess over $416
Over $1,307	45%

If John and Melissa had sought advice, a range of more tax-effective estate planning options could have been considered.

Option A: child account-based pensions

Melissa could have considered nominating the children to receive her superannuation death benefit. If the fund offers this option, Hamish and Luca could have started child account-based pensions. A child account-based pension is a superannuation income stream paid to a child upon death of the parent. The taxable portion of the pension would be taxed at adult rates but would attract a 15 per cent rebate.

With LITO, each could draw taxable income of up to $48,158 per annum in the 2011-12 financial year paying no tax, other than the Medicare levy.

Child account-based pensions are a very tax-effective way to provide for minors. However, a disadvantage of this strategy is that an anti-detriment payment is not available when a full superannuation death benefit is used to commence a pension.

The anti-detriment payment is an additional benefit that many super funds offer on death. This benefit can increase the total lump sum death benefit significantly.

Option B: testamentary trust

Alternatively, Melissa could have nominated the estate to receive her death benefit and set up a testamentary trust with superannuation proceeds. A testamentary trust is a trust set up in a person's will that comes into effect upon death.

When drafted correctly, the total death benefit can be paid into the trust tax-free. Distributions from the trust would be taxed at adult rates in the hands of the children. With LITO, each child can draw income of up to $16,000 per annum (no Medicare levy) in the 2011-12 financial year without paying tax.

The trust deed will usually contain a vesting date - the date on which the capital of the trust passes to the beneficiaries. If there is no vesting date specified, the trust assets will pass to the beneficiaries when the trust ends. In most states and territories, trusts have an 80 year lifespan.

The ability to nominate a vesting date is a particularly valuable feature for parents with young children. If the assets are left to the children directly, the kids can legally access the funds at age 18.

Similarly, children can elect to commute a child account-based pension at age 18 and must have the remaining capital paid out to them at age 25. Many parents might be concerned that the children may not make the best financial decisions at that age.

In contrast, a testamentary trust allows the parents to set a specific age for the children to access the capital, for example, age 25 or 30.

Other advantages of testamentary trusts include: certainty the deceased's intentions are implemented beyond death; and asset protection from bankruptcy and divorce for beneficiaries.

The optimal estate planning vehicle

The optimal option will depend on each family's situation, goals and objectives. For some parents, a combination of the two options might be appropriate.

An estate planning specialist can identify valuable strategic opportunities for tax management and asset protection, and advise on the optimal estate planning vehicle for children.

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