Australian Executor Trustees

Estate and Trustee Services

Estate affairs

Welcome to Estate affairs – September 2014 edition

IN THIS ISSUE

- **Dealing with stepchildren in super**
- **Super grandparents: are your clients missing out on a tax-effective intergenerational wealth transfer?**
- **Does your client have the capacity to make a Will?**

Dealing with stepchildren in super

By Julie Steed, Technical Services Manager

An issue that arises in blended families is in relation to stepchildren. Stepchildren are included in the definition of a child, however the step-parent/child relationship is severed upon the dissolution of the natural parent's relationship with the step-parent. This often happens as a result of divorce or death.

The severed relationship between step-parent and children has long been a principal in family law and was recently confirmed as the case for superannuation death benefits in ATO ID 2011/77. The Superannuation Complaints Tribunal (SCT) has also used this principal in deciding cases.[1]

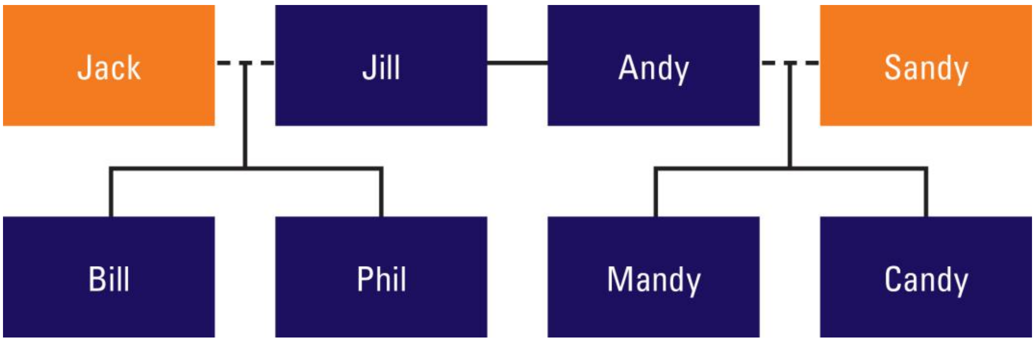
This means that the step-parent is unable to leave their superannuation benefits to their stepchildren since they no longer will meet the definition of a child. The children may however still qualify under financial dependency or interdependency.

An alternative is for the step-parent to formally adopt the stepchildren. If this occurs, the stepchild becomes a legally adopted child, who then has all of the legal rights and entitlements of a natural child. However, in practice this formality is rarely undertaken. It is particularly difficult in the event of a second marriage where the natural parent will generally object to their child being adopted by another person. It is more likely where one of the natural parents has died and the surviving parent remarries, although it is still uncommon.

Where there are blended families, the interaction between superannuation death benefits and careful estate planning becomes all the more important in order to ensure that the family's wishes are able to be fulfilled.

Case study

Andy and Jill married many years ago and each have two children from previous marriages, Mandy and Candy and Bill and Phil. Andy and his first wife had an acrimonious divorce. Jill's first husband died shortly before the birth of Phil.



Andy and Jill have made life long commitments to each other and to each other's children. It is Andy and Jill's wish that if one of them dies, the other inherits everything but on the death of the second of them, all assets are divided equally between their four children.Andy and Jill visit their financial planner who runs through the different scenarios, before calling in an estate planning specialist.

Andy and Jill have the following assets:

Ownership	Asset	Value
Joint	Family home	$600,000
Joint	Shares	$150,000
Joint	Cash	$50,000
Andy	Superannuation	$200,000
Jill	Superannuation	$30,000
Jill	Death benefit pension from Jack	$600,000
Total		**$1,630,000**

What would happen if they both passed away now?
Assume Andy and Jill were both involved in a serious car accident. Jill died at the scene and Andy died in hospital six weeks later. If they both died without a Will and without superannuation death benefit nominations, the following is the best outcome that could be obtained.[2]

As Jill died first, her share of the jointly held assets will generally pass to Andy due to the right of survivorship. Upon Andy's death, all of the jointly held assets will pass to his children. Andy's superannuation could pass 50 per cent to each of his children ($100,000 each) but none could pass to Bill and Phil as the death of Jill has severed the step-parent/child relationship.

The only way Bill and Phil could receive any of the superannuation benefit is if they were financially dependent or in an interdependency relationship with Andy. The same applies to Andy's children in respect of Jill's superannuation and this means her superannuation will be shared equally between her children. Assuming that the children were not living at home and not dependent, the distribution would be as follows:

Child	Amount received [3]	Calculation
Mandy	$500,000	($600,000 + $150,000 + $50,000 + $200,000) divided by 2
Candy	$500,000	($600,000 + $150,000 + $50,000 + $200,000) divided by 2
Bill	$315,000	($600,000 + $30,000) divided by 2
Phil	$315,000	($600,000 + $30,000) divided by 2
Total	**$1,630,000**	

What if some of the children were financially independent?
The situation is further complicated if one of the step children was financially dependent and the other was not. Consider the scenario where Candy was the only child living with Andy and Jill. Candy would qualify as being in an interdependency relationship with Jill and although the step-parent/child relationship is severed, Candy is eligible to receive one third of Jill's superannuation.

Child	Amount received[3]	Calculation
Mandy	$500,000	($600,000 + $150,000 + $50,000 + $200,000) divided by 2
Candy	$710,000	($600,000 + $150,000 + $50,000 + $200,000) divided by 2 and ($600,000 + $30,000) divided by 3
Bill	$210,000	($600,000 + $30,000) divided by 3
Phil	$210,000	($600,000 + $30,000) divided by 3
Total	**$1,630,000**	

Even if Andy and Jill had death benefit nominations in place to request 25 per cent to each of the four children, the superannuation fund trustees would be unable to make payments to the stepchildren of Andy and Jill since that relationship is severed upon their death. The stepchildren could only qualify if they were financially dependent or in an interdependency relationship.

Andy and Jill's adviser calls in an estate planning specialist who structures their affairs to ensure that their wishes are met in the most efficient and tax-effective method which will also provide protection for any children whilst they are minors. Testamentary and superannuation proceeds trusts are established via the Will and binding death benefit nomination put in place.

Conclusion

The examples above highlight how the severing of the step-parent/child relationship can result in outcomes that may differ from your client's expectations. It is essential to update client's estate plans, including superannuation, as family circumstances change and to utilise the services of experts who can assist with designing the desired outcomes.

[1] SCT determination D04-05/186 and SCT determination D99-2000/082.
[2] The intestacy laws vary in each state.
[3] Before the effect of any superannuation tax has been accounted for.

Super grandparents: are your clients missing out on a tax-efficient intergenerational wealth transfer?

By Julie Steed, Technical Services Manager

Grandparents are increasingly called on to provide financial support for their grandchildren, so it is important for you as an adviser to recognise whether financial dependency exists between grandparents and their grandchildren. When this dependency exists, there may be unique opportunities for you and your clients. For example, you may not be aware that alternatives exist beyond paying a lump sum death benefit via their estate to their grandchildren.

The payment of super death benefits and the taxation of those benefits have always been complicated, especially when the benefit is not being paid to the spouse or minor children of the deceased client. You need to recognise that if financial dependency can be established for both superannuation and taxation purposes, this can create the opportunity to pay a tax-free lump sum death benefit and/or a tax-effective death benefit income stream to a grandchild. While the focus of this article will be to examine the tests for establishing financial dependency under both superannuation and taxation laws, it will also identify the unique planning opportunity that exists within this space.

The unique planning opportunity

The majority of your clients will be over age 60 when they pass away, so establishing financial dependency can lead to many planning opportunities but most importantly, the payment of a tax-free death benefit income stream to a grandchild regardless of their age.

Where a grandparent has died aged 60 or over, financial dependency of a grandchild on the grandparent enables the grandchild to receive a tax-free superannuation death benefit income stream (instead of a tax-free lump sum death benefit). You should be aware that the definition of financial dependency under taxation law is more restrictive than under superannuation law.

Superannuation law

For superannuation purposes, the definition of ‘dependant’,[1] in relation to a person, includes the spouse of the person, any child of the person and any person with whom the person has an interdependency relationship. It is important to recognise that the word ‘includes’ in the superannuation definition has allowed the courts to extend dependency to those who were financially dependent on the client, at the date of death.

Under case law, financial dependency is a question of fact, and does not require that the deceased had an obligation to support the other person. Additionally, the fact that the dependent has income or separate wealth of their own will not necessarily mean they are not financially dependent on another. Whether somebody is financially dependent on another is a question of whether there was actual maintenance and support.

In Malek’s case,[2] a mother was found to be financially dependent on her deceased son and was able to assert rights to his superannuation benefits. Dependency was found to be determined by whether the dependant relied on the deceased to maintain them to a particular standard of living.

Superannuation case law allows a financial dependant to be partially or wholly dependent. Partial dependency implies that the financial contribution does not have to be relied upon for basic living requirements. It is sufficient if the contribution is supplementary to a person’s other income.

In Faull’s case,[3] a mother was held to be partially dependent on her son on the basis that he paid her board of $30 per week. The mother worked full-time earning over $700 per week so did not rely on the payment of board. By contrast, the deceased’s estranged father (who appealed against the trustee’s decision) was in poor health, unemployed and on a disability support pension. The decision was based on a number of factors. The deceased’s father was unable to present any evidence of financial dependency, therefore a death benefit payment could only have been made to him via a legal personal representative (and in this case, one did not exist). The deceased member’s intention was also considered. It was clear that he wished his mother to benefit, as she had been nominated as his preferred beneficiary less than two months prior to death. The deceased had not communicated with his father for a number of years.

In Noel v Cook,[4] the Federal Court said that the issue of dependency is not determined by merely considering the facts at the time of death, but ‘past and future probabilities need to be considered’.

In that case, a friend was held to be a dependant of the deceased member who had been paying him board and expenses for a long time and the payments had ceased for a period of time before the member’s death because the deceased had been forced to live in hospital for several months before he died.

Taxation law
The industry typically takes a conservative interpretation on financial dependency, which is supported by the Australian Tax Office (ATO). This interpretation covers the following:

• Financial dependence occurs where a person is wholly or substantially maintained financially by another person.
• If the financial support received by that person were withdrawn, would they be able to meet their daily needs?
• If the level of financial support is insignificant or minor, then the person is not likely to be regarded as a dependant.

As a general reference, the dictionary meaning refers to substantial financial support. However, the decisions made under some notable cases (as outlined above) don’t cite any need for the payments needing to be ‘substantial’ or ‘significant’.

The ATO has not expressed a detailed view on financial dependency in a public ruling (such as a taxation ruling). However, a number of private binding rulings (PBRs) show the use of the following precedents:

‘financial dependence occurs where a person is wholly or substantially maintained financially by another person.’

Conversely, some of these rulings appear to go further stating the test is also as follows:

‘If the financial support received by a person were withdrawn would the person be able to survive on a day-to-day basis? If the financial support provided merely supplements the person’s income and represents ’quality of life’ payments, then it would not be considered a substantial support. What needs to be determined is whether or not the person would be able to meet the person’s daily needs and basic necessities without the additional financial support.’

These tests appear to imply that only the necessities of life are relevant and the relationship between grandparents and their grandchildren are often not sufficient to establish financial dependency. For example, the following private binding rulings provide a further insight:

• PBR 64085 – Where the deceased had paid for social outings, medication, pocket money, chocolate, music CDs and costs for football for a grandchild will not be enough to establish financial dependency.
• PBR 40376 – Where amounts spent ‘tended to be on luxury items such as entertainment, rather than the child’s day-to-day living expenses’. In this example, financial dependence was not made out.

What practical issues should you consider?
Regularity and continuity is important when considering whether a person is financially dependent. From all the private binding rulings outlined above, the ATO has required that people show reliance on regular and continuous contributions.

Therefore, a dependant must be able to show that they have received financial or substantial help from the deceased to meet their basic needs regularly and over a continuous period. In many cases, lack of evidence will mean financial dependency cannot be established in the first place. The trustee of the superannuation fund needs evidence to make a decision. Retaining evidence of a deceased’s expenditure on their dependant will be critical to proving financial dependency. Additionally, the rulings indicate that where expenditure is asserted but not itemised, it may be difficult to convince a trustee of a superannuation fund, let alone the ATO, that payments went toward the daily essential needs of the dependant.

Checklist to determine financial dependency
• Have clients formalised these arrangements by diarising the payments and setting up regular direct bank deposits (to accounts where the grandchild’s parent is acting for the grandchild in applying the funds)?
• Did the person rely or depend on the deceased for contributions of financial support to maintain the person's normal standard of living?
• Were these contributions significant, regular and continuous in relation to circumstances involved?
• Were the contributions of a type that courts and tribunals have recognised? Types that have been recognised include:
  − direct financial contributions (such as paying for living expenses, food, clothing and shelter)
  − assisting in mortgage repayments
  − taking on a liability (such as where the deceased took out a loan on behalf of the alleged
  − dependant)
  − maintaining the alleged dependant's assets (such as repairs and alterations made to the alleged
  − dependant's home).
• Does sufficient evidence exist to support the above?

What does it all mean in practical terms?
In many situations clients are making payments or contributions to the upkeep, wellbeing and support of their grandchildren in an informal way (such as school fees and associated expenses). It is possible that partial financial dependency could arise under super law, however not under taxation law because it cannot be established that the money was used to wholly or substantially maintain the grandchild.

If financial dependency can be established the opportunity exists to pay a death benefit income stream to a grandchild. Consequently, as most grandparents are over 60, this means the pension payments will be tax-free. It is often overlooked that the tax law interpretation doesn't necessarily come in to play with this strategy.

The tax-free super death benefit income stream can be paid to adult grandchildren and no age restrictions exist which result in the income stream being not commuted and paid as a tax-free lump sum death benefit at a certain age (such as at age 25 which is generally imposed on children of a deceased client under age 18 who receive a death benefit pension from their deceased parent).

Child versus grandchild pension comparison
The following table compares and contrasts a child pension with a death benefit income stream paid under financial dependency to a grandchild.

	Child pension	Grandchild pension	
		Deceased or dependant is 60 years of age or older	**Deceased or dependant are less than 60 years of age**
Available to	A child of the deceased who is a superannuation and taxation dependant	Someone who was financially dependent upon the deceased at the date of death under both taxation and superannuation law	
Taxation of income/ pension payments	Taxed at adult marginal rate of tax less a 15% tax offset	Tax-free (non-assessable non-exempt income)	Taxed at adult marginal rate of tax less a 15% tax offset
Effective tax-free threshold	$49,753[5]	N/A	$49,753[5]
Pension payments	Minimum 3% and no maximum	Minimum 3% and no maximum	Minimum 3% and no maximum
Tax-treatment – within pension	Tax-free investment earnings (including capital gains)	Tax-free investment earnings (including capital gains)	Tax-free investment earnings (including capital gains)
Tax-treatment – lump sum withdrawals	Tax-free after first pension payment is received from the pension	Taxed at 20%[6] plus Medicare levy on the taxable component	Taxed at 20%[6] plus Medicare levy on the taxable component
Compulsory closure	Yes at age 25	N/A	N/A
Ability to rollover to another fund	No[7]	No[7]	No[7]

It is important to recognise that lump sum withdrawals from the death benefit income stream paid to a grandchild will be taxed.[8]

If the pension payments are tax-free (due to the grandparent being over age 60 at the date of death and as shown above) it would be worthwhile to receive the amount of required funds as a pension payment.

Conclusion
Clients are seeking innovative strategies when completing their estate planning. You should investigate the relationship between their clients and their grandchildren. Identifying the opportunity and seizing on the opportunity to pay a tax-free death benefit income stream to a grandchild due to financial dependency can be a significant outcome. So, can your clients be super grandparents and are they missing out on tax-efficient intergenerational wealth transfer?

1 Refer to Section 10 of the *Superannuation (Industry) Supervision Act 1993*.
2 *Malek v Federal Commissioner of Taxation* 42 ATR 1203 and 99 ATC 2294.
3 *Faull v SCT* [1999] NSWSC. 1137.
4 Noel v Cook (2004) FCA 479.
5 2012/13 tax scales including Medicare levy and Low Income Tax offset of $445.
6 Outside the prescribed period.
7 Consistent with ITAR reg 306-10.01.
8 Outside the prescribed period.

Does your client have the capacity to make a Will?

By Neil Page, Legal Counsel, AET Limited

From an estate planning perspective, one of the challenges we often face at AET is whether a client has capacity to provide instructions for the preparation of a Will.

'Legal capacity' is not defined by a statutory definition and hence a view of whether a client has capacity is a subjective one that needs to be assessed at the time the Will is prepared. However, in reality, the question of capacity invariably arises after the death of a client when the client's capacity to make a Will is in dispute.

Mental incapacity is one obvious form of incapacity and can be permanent, such as mental illness, brain injury or dementia, or temporary for example, due to a short-term illness or temporary injury.

This article sets out the issues that confront our estate planners when considering whether the client has 'testamentary capacity' to make a Will – that is, the mental capacity to understand the effect of making a Will, the extent of their assets and an appreciation of possible beneficiaries.

Testamentary capacity

The common law test for testamentary capacity contains four elements. The well-known judgment of Cockburn CJ in *Banks v Goodfellow* sets out those elements as follows:

'It is essential to the exercise of making a Will that a testator:

- *understands the nature of the act and its effects*
- *understands the extent of the property which is being disposed*
- *shall be able to comprehend and appreciate the claims to which he ought to give effect; and, with a view to the latter object,*
- *that no disorder of the mind shall poison his affections, pervert his sense of right or prevent the exercise of his natural faculties — that no insane delusion shall influence his will in disposing of his property and bring about a disposal of it which, if the mind had been sound, would not have been made.'*

The test in *Banks v Goodfellow* remains relevant today and is applied consistently across all Australian States and Territories.

Obligations of the estate planner

When capacity is in doubt, and in order to be satisfied about the testator's capacity, it's good practice for any estate planner, who is called upon to make a Will, to arrange for a medical practitioner to assess the testator.

It's common practice for the estate planner to subjectively assess whether there is a lack of testamentary capacity. This preliminary assessment involves looking at warning signs and using basic questions and answers to gain an awareness of the client's understanding. When incapacity is identified, it's normal practice to inform the testator that they should consult a medical practitioner to assess their capacity. As part of this process, we would write to the requested medical practitioner asking them to assess their patient's capacity citing the relevant *Banks v Goodfellow* principles set out above, albeit in more modern wording.

A medical practitioner with expertise in cognitive capacity assessment will, understandably, be more persuasive than the client's general medical practitioner. It is a specialist area and the better the medical advice obtained, the better the prospect of that advice being accepted in Court in the event that the Will is contested.

The request to obtain a medical opinion is sometimes met with concern from the client about its need and potential cost. These concerns can be dealt with by explaining that the costs of not getting it right in the first place could far outweigh future costs if any dispute is dealt with by litigation.

As part of this process, the estate planner must keep exacting file notes addressing the *Banks v Goodfellow* criteria as well as notes of their general conversations with the testator over the period of their consultation(s). It is important for the estate planner to be aware of the medical history of the client, and for the medical practitioner to have a client's full medical history when seeing the client. While this is often not readily available in a timely manner, timing is often critical as instructions are often left to the last moment, and can lead to what we call a 'death bed Will'.

At the Court level, a key factor in assessing capacity will be the evidence offered by lay witnesses whose knowledge of the testator over a longer period of time will be relevant.

When is testamentary capacity assessed?

Testamentary capacity should be assessed at the time when the instructions to prepare a Will are provided. If a testator has lost some faculties between giving instructions for a Will and the execution of it, it's important to understand:

- whether, at the time the Will-maker gave instructions, they had the ability to understand and give proper consideration to their matters discussed above
- whether a document gives effect to their instructions
- whether those instructions continued to reflect their intentions
- whether, at the time the Will was executed, the testator knew what they were doing and, therefore, had sufficient mental capacity to carry out the signing act.

Undue influence

When assessing a client's testamentary capacity, the estate planner must exclude 'undue influence', that is, any interference with the client's true wishes and intentions by another person. Generally, undue influence benefits the person exerting the influence and we are seeing more clients where this may be a factor in the Will-making process.

This form of abuse can be difficult to assess and often arises when a testator is frail or elderly and depends on others for physical or emotional support. Our experience shows that warning bells are raised when:

- the client is elderly, isolated and has no direct descendants and a third party (the abuser) wants to play an active role in organising the client's Will, often to their own advantage
- significant changes are made to an existing Will that provide an advantage to the alleged abuser
- the alleged abuser acts as a carer for the testator and, in some instances, moves in to the testator's home
- the testator is brought in to our offices by family members to enable them to alter an existing Will and it is obvious that capacity is an issue. In these instances family members will be requested to leave the interview room so that instructions made by the testator may be received away from any influencing factors.

You should always be wary of cases where 'interested' members of the family attempt to persuade others to change their Wills.

Conclusion

If you have a client whose Will is disputed, your long-term personal knowledge of their affairs may be relevant evidence in determining your client's testamentary capacity. Hence, it is important to ensure that you keep detailed notes of conversations and instructions with clients – as these may play a part in assessing your client's testamentary capacity, especially if you took instructions close to a period when capacity became an issue.

If you have any questions, or need more information, please call us on 1800 882 218 or visit www.aetlimited.com.au

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