Perpetual

Tax implications when receiving an inheritance

By Perpetual Private Insights

31 March 2021

Although it may not be top of mind, pre-emptively considering the tax obligations of your beneficiaries is important when planning for a wealth transfer.

This article was first published as an Advertisement Feature on bbc.com and was created by BBC StoryWorks, BBC Global News Limited, on behalf of Perpetual.

Benjamin Franklin once said there are only two things certain in life – death and taxes.

These are things people don't necessarily like talking about.

Conversations with beneficiaries early on or during estate planning can ensure all parties are aware of potential tax outcomes and can enable funds and assets to be managed to maximise value, not minimise. This means beneficiaries can receive what was intended for them by a loved one. Without considering tax implications, beneficiaries could pay a high price. While the magnitude will clearly depend on specific circumstances, in a worst case scenario beneficiaries may end up significantly out of pocket, says Catherine Chivers, Senior Manager – Strategic Advice, Perpetual Private.

What are the major tax obligations to consider?

Taxation is one of the more complex areas to navigate when receiving an inheritance.

Even though Australia doesn't have an inheritance or death tax as such, there are still elements that must be contemplated, including those related to superannuation death benefits, capital gains tax (CGT) and matters associated with earning an income from the deceased's estate.

The tax payable upon the receipt of an inheritance can be impacted by a range of factors. This will often include elements such as the personal circumstances of both the deceased and their beneficiaries, including their tax residency status, where assets are owned or situated and how a beneficiary is treated for superannuation and tax law purposes.

Source: Getty Images

Superannuation

Superannuation is generally the second largest monetary sum people pass on after their family home, and it can lead to significant tax implications for beneficiaries, sometimes resulting in an almost “quasi death tax”, according to Chivers.

“When an individual passes away, if they don’t have a spouse, they will generally want their superannuation to pass to their adult children,” she says.

“For the taxable component of that superannuation death benefit, that can trigger tax of 15% or 17% in circumstances where the Medicare levy needs to be taken into account. Having a strategy in place before a person passes away could be helpful to maximise the amount a beneficiary ultimately receives, and that’s usually something warmly welcomed by both the deceased and the person receiving the inheritance.”

Dealing with superannuation death benefits can be complicated, says Chivers, but thinking about who you may want to receive your superannuation is a good place to start.

Superannuation law dictates who can receive a superannuation death benefit, but its tax law that determines the ultimate level of tax paid by a beneficiary on those monies.

Where the superannuation death benefit goes to the spouse of the deceased, it can usually be received in a tax effective way. But if it is, say payable to an adult child who is completely financially independent, that will likely be a different scenario entirely, notes Chivers.

Source: Getty Images

“The question then is what do they do with their investments – in what structure and how should it be invested?”

There are certain time limits that need to be adhered to when it comes to financial decision making after the death of a spouse or partner, although the probate process is likely to take some time.

Having an up-to-date will, estate plans and other key documents can minimise some of the issues a surviving spouse faces upon their death. For example, where there are entities such as trusts and companies controlled by one person, understanding how the nature of any control will pass to others is key.

A concern that some may have, is the ability for previous spouses to make a claim upon their estate, at some future point in time.

“If superannuation is payable to a nominated beneficiary it generally can be difficult to be challenged, but if there are assets within the estate of the deceased spouse, in certain circumstances first spouses may have standing to challenge,” says Chivers.

“This includes where it was deemed inadequate provision was made for them during their life or if they were financially reliant upon the deceased upon the time of death.”

Issues with first spouses can also arise if financial structures haven’t been revisited in a long time and perhaps the first spouse is still a shareholder in a company or trust, says Chivers.

What should older inheritors do to build financial literacy?

Trying to build financial literacy during a period of loss for a surviving partner can be very difficult while they are also grieving, so it's often optimal for both spouses to be involved in a couple's financial affairs from the outset.

This ranges from the consideration of having joint bank accounts to ensure funds aren't frozen upon the death of a spouse, to setting up and running financial structures and being part of financial decision-making and estate planning together as a team.

Not only does this make the process of wealth transfer less challenging when a partner passes away, but it gives both parties confidence, and prevents the grieving spouse from having any financial surprises upon the death of their loved one, says O'Reilly. It also helps them to understand the wishes of their loved one and how their estate is to be dealt with.

Source: Getty Images

Transferring an existing income stream to a spouse, that is, structuring a reversionary pension, can be beneficial if it remains in the concessionally taxed superannuation environment, says Ed Ryan, Associate Partner, Perpetual Private.

"Where there will only be an adult child(ren) likely to benefit from the deceased's superannuation, strategies can be considered, and as appropriate, put in place during the lifetime of the deceased that mean any ultimate death benefit is received in a more tax effective manner," he says.

"In the unfortunate situation where you know you only have a short time to live, having the ability to withdraw your superannuation means you can decide who should benefit from these

funds. If you are over age 60, these can be received tax-free. Or, if you prefer, that money can simply form part of your estate as cash and then dealt with by the will accordingly. ”

Capital Gains Tax

In Australia, the family home can be exempt from CGT if it’s sold by a beneficiary within two years of the deceased passing away. And, a partial exemption may be available where the home wasn’t always their main residence, says Chivers. If there is a spouse or someone else living in the home indefinitely, that tax-free period can usually be extended, she says.

For a non-resident beneficiary, however, “inheriting the family home can be subject to tax, depending on the tax laws in the country where the person holds tax residency,” says Chivers.

For assets often subject to CGT such as investment properties, shares and managed funds, it can be more complex. Chivers says death isn’t a CGT event in and of itself – that is, there is usually no CGT payable when an asset passes to a beneficiary. But if the beneficiary chooses to sell the asset at some later stage, CGT may then be an issue.

For non-resident beneficiaries, CGT can become applicable for certain assets they are inheriting, even if they are not sold.

“If a non-resident beneficiary inherits shares and managed funds it could trigger a CGT liability within the estate, which is an element that needs to be considered, as there’s the possibility one beneficiary may be disadvantaged over another,” Chivers says.

“If you have a pool of money and two children that are beneficiaries, with one a resident and one a non-resident, there could be significant tax inequalities there, depending on how the will is structured.

“It can get complicated, but you can, for example, have a strategy where if someone is sitting on cash, that can be directed to the non-resident and the resident sibling can receive other assets in order to equalise the inheritance ultimately received by both children.”

Seeking advice in putting an estate plan together and bringing in broader family members to discuss and hopefully determine which assets should be distributed to whom, may well minimise the tax liability overall. This can be a helpful process in avoiding inequalities between adult children beneficiaries.

Earning an income from an inheritance

Generally, there are no tax implications with receiving a cash inheritance, but extra considerations are needed when the beneficiary is receiving Centrelink benefits, as they could then exceed means test thresholds which may then reduce the payment or benefits received – or even eliminate it entirely, which can have further flow on issues, says Chivers.

However, if you are earning income from inherited assets such as managed funds and shares the situation is different. If assets move into your name, the income received plus any later capital gains arising if that asset is sold at some future point can form part of your assessable income, which can affect the amount of tax paid plus may have flow on effects to Centrelink payments, if applicable, says Ryan.

The importance of tax planning that considers your beneficiaries

The key to minimising the tax payable for beneficiaries is for the person passing on their wealth to formulate a succession plan with expert guidance and to communicate that plan to their beneficiaries, says Ryan.

Source: Getty Images

“The plan will be different for everyone depending on their stage of life and their wealth, the assets involved and how they are structured, and how complicated the family affairs and dynamics are,” he says.

“That plan needs to be revisited every three to five years, or when there is a major change in the family’s situation, needs or objectives. It needs to be flexible so it can change as their kids grow older – for instance, one or all of them might be overseas now but in 10 years’ time they might come back.”

Having a plan is vital, but it also needs to be communicated, says Ryan.

“One of the major reasons why many intergenerational wealth transfers result in stress and family disputes is that often the beneficiaries are not included in the planning process,” he

says. “Families typically spend more time planning Christmas lunch than they do discussing the legacy they wish to leave to future generations and how best to realise those wishes.”

Philanthropy can also play an important role in family succession planning, says Ryan. It can be the ultimate expression of a family’s values and support of the community, while at the same time engaging and connecting these family values with the next generation.

“It’s a great way to leave a legacy, but it can also have tax benefits and can play a really important part in a family’s estate planning, ” he says.

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