THE STRATEGY series

Alex Koodrin
National Technical Manager

Estate planning and life insurance

Estate planning is an essential part of financial planning. Trends such as: Australia's growing aging population; the increase in marriage breakdown and blended families and the rise of non-real estate assets, have all enhanced the importance of estate planning advice. And this frequently includes a need for life insurance and appropriate ownership structures to be considered. Effective estate planning (including life insurance) ensures that on the client's death all assets are distributed to the right beneficiaries at the most appropriate time. Assets can be broadly divided into estate assets and non-estate assets.

Estate assets

These are assets that are personally owned either outright or as tenants-in-common with another person or entity. Some assets, such as property owned as joint tenants, are not estate assets and ownership passes to the surviving joint tenant. Only estate assets can be distributed via a valid will. The most common estate assets are as follows:

- Personal property, such as a car, collectibles, property
- Debts and loans
- Share of assets owned as tenants in common
- Share of any partnership assets
- Shares in proprietary company held by the deceased
- Right to recover monies owed to the deceased
- Rights held under a contract
- Life insurance and superannuation benefits paid to the deceased's estate.

Non-estate assets

Non-estate assets are those that cannot be gifted in a person's will, either because the person is not the legal owner (such as a family trust), the assets are owned as joint tenants, or where a facility exists whereby the asset can be passed to a beneficiary while bypassing the deceased estate. The most common non-estate assets include:

- Assets held by the deceased as a joint tenant (including life insurance policies)
- Assets held in trust
- Assets owned by a company of which the deceased was a director
- Partnership assets
- Life insurance and superannuation benefits paid directly to beneficiaries.

As we can see from the above, life insurance and superannuation benefits can either be estate or non-estate assets, which will depend on ownership and beneficiary structures and will be dictated by the client's needs and objectives.

Assets owned as joint tenants

Full ownership of these assets will pass to the surviving joint tenant or tenants upon the death of one, so it follows that a joint tenant cannot deal with this asset in his or her will. Married and de facto couples usually hold ownership of their principal place of residence as joint tenants so that the asset will pass to the surviving partner. There is a presumption of joint tenancy for many personal assets, such as bank accounts, shares, furniture, etc. Real estate owned as joint tenancy can be easily converted to a tenancy in common, even if the other joint tenant disagrees. This may be desirable following marriage separation or divorce. Tenants in common own a property in fixed and sometimes unequal shares (such as 80% to one party, and 20% to another).

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Life insurance (non super) policy structure

Life insurance in Australia is largely governed by Commonwealth legislation, the principal acts being the Life Insurance Act 1995, administered by the Australian Prudential Regulation Authority (APRA), and the Insurance Contracts Act (ICA)1984 and the Financial Services Reform Act, administered by the Australian Securities and Investment Commission (ASIC).

All life insurance policies have two essential structural components: a policy owner (or policyholder) and a life insured. The life insured must be a natural person, whilst the policy owner can be a natural person, a corporation or a trust. Even though there are no legislative restrictions on the number of policy owners or life insureds, in practice, insurers restrict the maximum number of policy owners and lives insured to no more than five.

A common structure for personal life insurance policies is for a person to be both life insured and policy owner (self-ownership). For a term life policy, this would mean that any death benefit would be paid to the person's estate. For example, Bill has a $500,000 term life policy with CommInsure, where he is the life insured and policy owner. If Bill were to die, the claim proceeds would be paid to his estate. The payment of these proceeds would normally be subject to probate of Bill's will or letters of administration (if Bill died interstate), which could be a lengthy process. The only exception is if the policy (or policies) with a particular insurer does not exceed $50,000, in which case the life company could pay the money without requiring probate or letters of administration.

Nomination of beneficiaries

However, for term life policies, there is also the option of nominating a beneficiary under section 48A of the ICA, which enables the insurance proceeds to be paid to a third party beneficiary, bypassing the policy owner's estate. The restriction under this section (subsection (2) (b)) is as follows: provided that 'money paid under the contract does not form part of the estate of the person whose life is insured'.

What does this mean? Using Bill's example, he could nominate his wife Jill as a beneficiary under the policy, which would mean that upon Bill's death, the $500,000 claim proceeds would be payable to Jill and not form part of Bill's estate. He could not, however, nominate both Jill and his estate as beneficiaries (the share allocated to nominated beneficiaries should equal 100% of the claim proceeds). As you can see, this option could be a very valuable estate planning tool, particularly if there were potential challenges to Bill's estate. Again, there is no legislative limit on the number of beneficiaries a policy owner can nominate, but for administrative reasons, life insurers generally restrict the number to a maximum of 10.

Advisers should always look at the particular insurer's PDS and/or policy document to understand how nominations of beneficiaries are treated under each contract. For instance, a number of insurers only allow nominations if the policy owner and life insured are the same, others are more flexible. The latter, including CommInsure, would allow a situation where Bill owns a policy in Jill's life (he is the owner, she is the insured), for him to nominate their son Phil to receive the insurance proceeds.

What if the nominated beneficiary is a person and dies before the life insured? Once again, we should look at the terms of each insurer's contract. Most life offices will treat the nomination as revoked, and the proceeds will be paid to the policy owner (if still alive) or to his or her estate. Some companies, such as CommInsure, will pay the nominated beneficiary's legal personal representative (estate), whilst others will pay the nominated beneficiary's estate only if the beneficiary dies after the life insured but before a claim is paid. In all cases, any nomination of beneficiary will be revoked if policy ownership is transferred (assigned) to another person or entity.

What situation is better? Assume David has a self-owned term life policy, and has nominated his adult married children, Mark and Chloe, as beneficiaries. Mark dies, and before David has the opportunity to update his nominated beneficiaries, he himself dies a week later. It is very likely that David would have wanted his son's family to benefit from the insurance proceeds if his son were to predecease him. Under CommInsure's policy, the proceeds would be paid promptly to Mark's estate. Under the policies of most other insurers, Mark's death would mean the nomination in his favour would be revoked, and the proceeds would be paid to David's estate and therefore become an estate asset. It is unlikely that David would have addressed the distribution of these proceeds in his will and it is possible that the proceeds would be subject to challenges to David's will.

Policy ownership

Ownership of life insurance policies in Australia is generally set up as joint tenancy. There is some doubt as to whether a life policy can be legally owned as tenants in common (at common law, but not in equity), and therefore it is preferable to register multiple ownership as a joint tenancy. CommInsure and most other insurers will not issue a policy owned as tenants-in-common. It is therefore unlikely that a joint tenancy could be severed and converted to tenancy in common. What does this mean in practice?

John and Mary, a happily married couple, have set up a term life policy with themselves as lives insured and policy owners. If either dies, the policy proceeds will go to the surviving partner. Neither John nor Mary could therefore distribute any insurance proceeds through their wills. They could, however, nominate their children as equal beneficiaries in which if either died (or both died simultaneously), the proceeds would be received by the children, outside their estates.

Notional estate

Each Australian state and territory has family provision legislation, which may rectify a lack of provision made in a person's will for certain family members and dependants of the deceased. In most jurisdictions, this legislation only applies to estate assets that have been distributed via a valid will. This means that non-estate assets, such as life insurance policies with a nominated beneficiary or those not owned by the life insured, cannot be challenged in these jurisdictions.

The only current exception to the above is in New South Wales, where family provision legislation extends to a 'notional estate' as well as the actual estate of the deceased. This notional estate would include property subject to any act or omission by which that property became held by another person or subject to a trust, and would encompass transactions such as nominating a life insurance beneficiary or a superannuation beneficiary or not severing a joint tenancy of real estate. In other words, the courts in NSW may order that life insurance or superannuation proceeds are clawed back in providing for a disappointed beneficiary. Therefore, the only sure way to ensure that the right people (in the eyes of the testator) receive the appropriate life insurance proceeds in NSW is to have them be the policy owner(s) and for the testator to be the life insured.

Insurance policies and bankruptcy protection

Life insurance policies are generally protected from creditors, unless a person had entered into a contract that provided expressly for the proceeds to be applied in payment of a debt. This would apply to life policies effected on a person's life or on the life of the person's spouse (see section 204-05 of the Life Insurance Act 1995).

The right structure

The proper structure of a life insurance policy understandably depends on the needs and objectives of clients. In most situations of personal insurance protection, self-ownership with a nomination of beneficiaries (to facilitate prompt payment of proceeds outside the deceased estate) would likely be the appropriate structure. However, there may be a need to set up alternative structures based on both personal and business needs of clients.

For instance, there may be a need for a testamentary trust, in which case there should be a self-owned policy with no nomination of beneficiary, so the proceeds can be paid to the estate and be governed by the client's will. Another example may be where a policy where your client is the life insured, and a third party, such as an adult child, owns the policy in case there are challenges to the client's estate and a nomination of beneficiary may be challenged under the notional estate legislative provisions. In this situation, your client can still pay the policy premiums, but has no control over the policy.

Testamentary trusts

These are simply trusts that are established by a person's will and come into effect after death. They are generally discretionary trusts (although they may also be fixed trusts) and are usually set up for the following purposes:

- Protection of assets
  - o Protects assets against matrimonial claims against children's spouses and/or the future spouses or partners of your widow or widower as well as protection against their bankruptcy
- To provide for beneficiaries with a disability
  - o Special disability and other protective trusts can properly look after family members who either suffer from severe mental or physical disabilities or who are vulnerable due to spendthrift tendencies or addictions to drugs and alcohol
- Tax advantages
  - o Testamentary trusts provide minor children (under 18) with access to adult tax-free thresholds. Therefore, each minor beneficiary can receive a tax-free distribution of $6,000, with normal adult marginal rates of tax.

If the client wishes insurance proceeds to be distributed via a testamentary trust, he or she should set up the policy as self-owned with no nomination of beneficiary. The appropriate testamentary trust will be set up through the client's will.

Superannuation

As mentioned above, superannuation death benefits (both investments and life insurance) may be an estate or non-estate asset. As for ordinary life insurance, there may be a benefit in nominating the deceased's estate (Legal Personal Representative) to receive the death benefit in order for a testamentary trust or a superannuation proceeds trust (where the beneficiaries are restricted to superannuation tax dependants, such as a spouse or minor children) to take effect. This nomination may either be binding or non-binding on the superannuation fund's trustee: with the former, the super fund trustee is bound to pay the beneficiaries in accordance with the member's wishes; with the latter, the trustee will consider the member's nomination, but retains an overriding discretion to pay the death benefit in the way it decides. Where a superannuation death benefit is paid to a non-dependant for tax purposes (such as an adult, non-financially dependent child), up to 31.5% tax is payable on the insurance proceeds.

Separation and divorce

It is particularly important for advisers to address estate planning and life insurance issues if a couple suffer a marriage breakdown. Statistics show that the median duration of separation to divorce is 3.6 years, so it is vital to look at a person's will (separation does not automatically revoke a will), ownership of assets (including insurance and superannuation policies), nomination of beneficiaries, and so on. Failure to do so may bring on major undesired consequences for disappointed beneficiaries.

Case study

Frank and Patricia separated in early 2008, family law proceedings were initiated and the couple had not applied for a divorce. At the date of separation, the family home was owned in joint names, both parties had left their estates to the other, both had set up death benefit nominations to the other with their respective super funds, and there was a self-owned life insurance policy with no nomination of beneficiary. Frank died while the family law proceedings were under way, though they became irrelevant after Frank's death. It turned out that Frank had not changed his will, life insurance policy, his superannuation fund's death benefit nominations, nor had he given any thought to severing the joint tenancy. Therefore, the balance of Frank's estate went to Patricia, as did the family home through the right of survivorship, and Frank's superannuation benefit. Consequently, the unintended result of Frank's inaction was that the two adult children from his first marriage were disappointed beneficiaries. Though these children could make application under the family provision legislation in their state, apart from NSW, the only assets that could be challenged would be the balance of the estate, including the life insurance policy.

If Frank had had a financial adviser who provided him with full service and who had been told by Frank of his changed situation following his separation, but who had not advised him to address the issue of ownership of assets, that adviser could be liable for negligence and facing a claim for damages.

Summary

Estate planning, of which life insurance advice is a vital component, is becoming increasingly important due to changes in Australia's socioeconomic structures and directions.

Life insurance, as well as superannuation death benefits, may either be an estate or non-estate asset, depending on the specific needs and objectives of clients.

Advisers should immediately address their clients' estate planning needs in view of changed circumstances, such as separation or divorce.

Important information

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