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DON'T FORGET THAT EXIT STRATEGY

Michael Harkin

With the rush to purchase property via their self-managed super funds (SMSF), trustees are overlooking what will happen to this so-called “lumpy” asset should they become disabled or die.

They're quick to calculate potential investment gains and how to manage loan repayments, but they're giving scant attention to properly planning their “exit” strategies.

Sadly the consequences of this oversight could be the fire sale of the property and it being sold well below its market value or of beneficiaries being liable for hefty death benefits and capital gains liabilities.

Insurance – the critical component

Key to the success of any exit strategy is insurance cover.

When SMSF trustees enter into a limited recourse borrowing arrangement to purchase assets (most likely real estate) they generally take out insurance cover on that purchase. However, few consider life and/or total and permanent disability (TPD) insurance.

This is critical cover as it can assist trustees holding large assets in their funds when the time comes to pay death or disability benefits in a SMSF.

Using a case study, let's take a look at how things can go wrong not having the right insurance and later, how to mitigate against this.

George is a speech pathologist and Barbara works part time in the business as receptionist/secretary. They have transferred their superannuation balances (\$161,500 and \$160,000, respectively) from other funds to commence their SMSF. They are the only members.

They have also used their new fund to purchase the property they conduct their speech pathology business from. They intend using

rent and contributions to meet interest and principal repayments and reduce the loan, taking it to nil over time. They also intend adding their rollover funds to the borrowings.

This arrangement is reliant on George's health continuing. If he becomes disabled and is unable to operate his business or dies, the rent may not get paid and contributions would cease. Where the SMSF is concerned, its cash flow would stop but the obligation to meet the interest and principal repayments to the bank would continue.

It would have used all rollover funds to contribute to purchasing the property and because most subsequent rental and contribution income (after tax) had been used to meet loan repayments, only minimal funds would remain.

An additional burden for George and Barbara would be the fact that they have no employment income. Although they would be able to commence an income stream, there would be no liquidity in the SMSF to enable payment of a pension.

So what should George and Barbara have done?

If George had taken out TPD and life cover, money would have been available in the SMSF to meet loan obligations. The fund may still have suffered a loss of rent and contributions, but it would have been in a position to either pay out the loan or continue to meet the loan repayment schedule – at least until the property could be sold in an orderly manner.

There are two types of TPD insurance cover:

- ‘Any occupation’ means the insured person is paid if they cannot work in the occupation which he or she is reasonably trained for or qualified in
- ‘Own occupation’ applies when the insured person cannot continue in the occupation held at the time of injury or illness.

Let's take a look at George and Barbara's SMSF transactions under the borrowing arrangement – firstly without and then with insurance in place.

Table 1: Cash-flow table

Cash Flow			
	George	Barbara	Total
Rollovers	\$ 161,500	\$ 160,000	\$ 321,500
SMSF Borrowing			\$ 550,000
Total funds			\$ 871,500
Property			-\$ 800,000
Incidental Expenses			-\$ 70,000
Remaining Funds			\$ 1,500

Assuming all contributions and rent (after tax and expenses) have been used to reduce the loan and at the time of George's death or disability, the loan has been reduced by \$30,000, the SMSF balance sheet would look as follows:

Table 2 : Assets and Liabilities without insurance

Assets & Liabilities (no insurance)	
Assets:	
Cash	\$ 1,500
Property	\$ 800,000
	\$ 801,500
Liabilities:	
Bank Loan	-\$ 520,000
Balance for Members	-\$ 281,500
	-\$ 801,500

The balance sheet confirms there are no funds available to meet bank obligations.

However, if the SMSF trustee had taken out life and TPD cover on George for the amount of the loan – \$550,000 – the balance sheet, following payout of the claim and clearance of the loan, would look much different:

Table 3: Assets and liabilities with loans been paid out

Assets & Liabilities (loan paid out)	
Assets:	
Cash	\$ 31,500
Property	\$ 800,000
	\$ 831,500
Liabilities:	
Bank Loan	-\$ 00
Balance for Members	-\$ 831,500
	-\$ 831,500

Covering the liability of the fund with insurance to provide for eventualities is hugely beneficial. Conversely, without insurance, there is a potentially large exposure unless the fund has sizeable assets it can sell to provide short term liquidity – particularly until new tenants can be installed and rent payments recommence.

Creating a reserve

Creating a reserve in the SMSF would enable a proportion of the fund to be held, not in a member's account but in a separate account – a reserve. On the death of the member, only the balance in that person's account would need to be paid out, meaning the balance in the reserve remains within the fund.

What this would mean for Barbara if George was to pass away was that she would be able to retain the benefit in super, but not in her member's account. This would allow the planning of an exit strategy on her death.

The first stage of that planning is considering the best options with regards holding the policy and payment of premiums, within the SMSF structure.

When a fund member is insured, premiums are usually paid from the member's account and when the policy is paid out on their death, the proceeds are credited to the member's account.

These proceeds are then typically paid out as death benefits – either by commencing an income stream or payment of lump sums. If the payment is to adult children, the proportion relevant to the insurance policy (there is actually a formula which is applied) will be taxed at an extra 15% (in addition to the usual 16.5%) because it is deemed an 'untaxed element'.

However this tax does not apply when the benefit is paid to a spouse. In most instances surviving spouses will draw an income stream during their lifetime and following their deaths, the benefit will be paid to the children.

When a SMSF enters into a borrowing arrangement, the overall liabilities and the means of dealing with them, take on a new dimension.

This is especially so when it comes to paying benefits to beneficiaries. For example, if the benefit recipients are the deceased member's adult children there is generally no option but to pay the balance out of the fund to those children. Without insurance the main options available are as follows:

Table 4: Without insurance

Available options	Consequences/problems
Sell property and pay out loan	Market conditions may not be ideal
Transfer property to adult children, who take over loan	Messy, will require new loan arrangements, possible deemed contributions, children may not be in a position to provide bank security, costs to arrange
Sell property to adult children, pay out loan and pay remainder as death benefits	May need temporary finance which children may not be able to obtain, costs to implement

To mitigate against the above problems, the use of a reserve would be a viable option.

For practical purposes, a reserve can be considered to be a separate member account within a SMSF and is funded by an allocation of income before distributing the remaining income to the members. Reserves share in a portion of fund income and expenses.

Reserves are permitted provided the SMSF trust deed does not prohibit them (SIS Act s 115); and the trustee maintains a strategy (a 'reserving strategy') for managing the reserves, consistent with the investment strategy (SIS Act s 52(2)(g)).

A well drafted SMSF Trust Deed will usually permit the trustee to create and maintain reserves, including for the purposes discussed in this article.

Let's apply this learning to George and Barbara. They decide to allocate the first \$4,000 of SMSF income to an insurance reserve account, before allocating the remaining income to the members' accounts, knowing it will cover the life and TPD premiums for George.

This account will show the transactions credited to establish the reserve; and the amount used to pay the premiums, with a small balance remaining. This action will be repeated each year by allocating slightly more than the required premiums.

If George passes away or becomes severely disabled, the insurance company will pay the proceeds of the policy to the SMSF, and the trustee will credit that money to the insurance reserve.

The ATO has stated that, in its view¹, the proceeds of an insurance policy should be added to the account from which the premiums were paid.

Assuming the SMSF trust deed permits, the trustee can credit those proceeds to the insurance reserve account and use the money received for clearing the borrowing. After clearing the loan, the balance sheet of the fund will be as follows:

Table 5: Assets and liabilities insurance paid out

Assets & Liabilities (insurance paid out)	
Assets:	
Cash	\$ 31,500
Property	\$ 800,000
	\$ 831,500
Liabilities:	
Bank Loan	-\$ 0
Insurance Reserve	-\$ 550,000
Balance for Members	-\$ 281,500
	-\$ 831,500

In this instance, the cash received from the claim on the policy will have been pooled with other assets and then used to clear the borrowing. As a result, although little cash remains in the SMSF, the insurance reserve now has a significant balance.

The trustee may clear the reserve over a number of years, through allocation of a certain amount each year. The amount which can be transferred will ordinarily count against the concessional contributions cap² of the recipient member(s) in the year of allocation, unless the amount is allocated (fairly and reasonably) to all members and the amount allocated to each person is less than 5% of their balance in the SMSF.

This can be a slow process. The alternative, if neither George nor Barbara will be making concessional contributions, will be to allocate \$25,000³ each per year (i.e. up to the level of their concessional contributions caps). Even that process will take about 10 years in their case, provided both are living.

Exit strategy on death

Once the SMSF has the necessary insurance safeguards and an insurance reserve in place, the next step is to prepare an exit strategy to deal with lumpy assets (such as property) should a member die.

An asset is considered "lumpy" when it represents a significant proportion of the total assets of a SMSF, and is relatively illiquid. Real estate is the most common form of lumpy asset in a SMSF.

When a member dies, SMSF assets must provide for a pension or pensions for certain dependants; and/or form part of a lump sum to be paid to beneficiaries, either in cash or in specie (or both).

Dealing with the lumpy asset could pose problems when a death benefit lump sum payment is to be made to a number of beneficiaries, and a capital gains tax possibly triggered.

Retaining the asset in the SMSF and paying a pension may only defer the issue until the death of the new pensioner, and the eventual need to pay out the asset, in specie, as part of the benefit. A death benefits tax of 16.5% (and possibly an additional 15% – tax on the untaxed element of the payment), may apply to beneficiaries.

The untaxed element of the payment will generally occur if a claim has been made for a deduction with regards the SMSF paying insurance premiums, even if no insurance benefit is included in the benefit payment.

To make the tax position clearer, let's assume George died several years ago and Barbara has recently passed away. We will assume the assets and liabilities of the fund are at the point we reached previously, except that the property value has doubled, as outlined below:

Table 6: Assets and liabilities when loan paid out

Assets & Liabilities (loan paid out)	
Assets:	
Cash	\$ 31,500
Property	\$ 1,600,000
	\$ 1,631,500
Liabilities:	
Bank Loan	-\$ 00
Balance for Member (Barbara)	-\$ 1,631,500
	-\$ 1,631,500

Because the SMSF benefits will now pass to their adult children, the property and cash will have to be paid out of the fund. This will potentially have a large tax impost:

Table 7: Tax Payable

Taxes Payable (benefits to adult children)		
Fund balance		\$ 1,631,500
Tax on Superannuation Death Benefit		
Untaxed element @ 15%	\$ 550,000	-\$ 82,500
Total benefit @ 16.5%	\$ 1,631,500	-\$ 269,198
Net payment to beneficiaries		\$ 1,279,802

Table 8:

	Action	Taxable	Tax Free	Total	Death Benefit Tax (16.5%)
Balance		\$ 1,081,500	\$ –	\$ 1,081,500	\$ 178,448
Year 1	Pension	-\$ 150,000	\$ –	-\$ 150,000	
	Contribute		\$ 150,000	\$ 150,000	
Balance		\$ 931,500	\$ 150,000	\$ 1,081,500	\$ 153,698
Year 2	Pension	-\$ 144,000	-\$ 6,000	-\$ 150,000	
	Contribute		\$ 150,000	\$ 150,000	
Balance		\$ 787,500	\$ 294,000	\$ 1,081,500	\$ 129,938
Year 3	Pension	-\$ 138,000	-\$ 12,000	-\$ 150,000	
	Contribute		\$ 150,000	\$ 150,000	
Balance		\$ 649,500	\$ 432,000	\$ 1,081,500	\$ 107,168
Year 4	Pension	-\$ 132,000	-\$ 18,000	-\$ 150,000	
	Contribute		\$ 150,000	\$ 150,000	
Balance		\$ 517,500	\$ 564,000	\$ 1,081,500	\$ 85,388
Year 5	Pension	-\$ 126,000	-\$ 24,000	-\$ 150,000	
	Contribute		\$ 150,000	\$ 150,000	
Balance		\$ 391,500	\$ 690,000	\$ 1,081,500	\$ 64,598
Change					\$ 113,850

The table anticipates no capital gains tax will apply on the disposal of the asset. On that basis, the total amount of tax payable by the SMSF amounts to over \$350,000 (\$82,500 + \$269,198 = \$351,698).

Because the SMSF only has one major asset, this gives rise to the possibility of a forced sale.

With proper exit strategies, the tax impact can be reduced. Let's look at some options.

Removing this tax requires early planning. If, instead of paying the insurance premiums from a reserve as previously suggested, the premiums for George's life policy are paid from a separate pension account in the SMSF. This could be started with non-concessional contributions.

Because the pension was commenced using only tax free funds, there would be no taxable component of the proceeds, so there could be no untaxed element. Saving = \$82,500+

Because the tax free pension account was about one third of the total member's benefits (about \$550,000 out of a total of \$1,631,500), the potential tax drops immediately from \$269,198 to about \$178,448 (\$1,631,500 less \$550,000 = \$1,081,500 @ 16.5% = \$178,448).

Although there is a potential saving of about \$90,000, there is still a significant amount of tax to pay, and insufficient cash to pay it with.

At this point the benefits of early planning could help reduce the tax problem. If, between the ages of 60 and 65, Barbara had withdrawn \$150,000 more than she required for her living expenses and contributed that as a non-concessional contribution, which was immediately applied to commence a 100% tax free pension, she will have reduced tax by about \$114,000, from almost \$180,000 to about \$65,000. See table 8.

Because the fund has about \$31,000 in cash and about \$65,000 tax to pay, an option is for one or more of the children to contribute to the fund, providing the cash to enable the property to be transferred to the children, in specie.

All up, the exit strategy has been put into effect with little disruption to the finances of the ultimate recipients.

Planning for a 'non-exit' strategy

An alternative option is to keep the property in the SMSF – a so-called 'non-exit' strategy.

Intergenerational transfers can occur, with the asset remaining in the fund and the children becoming members. However, the deceased member's benefit must still be paid out when passing to adult children or to the estate.

In this regard, problems can arise when the fund's liquid assets are significantly less than the deceased member's interest in the fund. Here are several options to overcome that:

Table 9:

Available options	Issues
Children transfer super from other funds	Viable, so long as balances are sufficient
Children contribute personal money	May have available money. May be able to use cash in the fund, in a series of 'round robin' payments
Use a Reserve	Needs to have been established at an earlier date

Let's now look at how we can use a reserve as a planning option, once again using the example of George and Barbara. Let's assume the trustee used the fund's insurance reserve (which received \$550,000 when George died) to pay insurance premiums. Although the cash received was used to clear the bank loan, a balance remained in the reserve account.

Rather than transferring any funds to the member's accounts as was previously the case, we now assume the full amount of the reserve was retained.

Effectively, the reserve does not become part of the benefit account of a member, but grows (i.e. reflects the increase in property value) in

the same proportions as the member accounts. Table 10 indicates an approximation of the position at Barbara's death:

Table 10:

Reserve Retained		
	Reserve	Barbara
Balances (George's death)	\$ 550,000	\$ 281,500
Assumed net income (10 years)	\$ 218,366	\$ 135,189
Assumed pension payments (10 years)	-\$ 353,555	
Assumed investment growth (property to \$1.6m)	\$ 529,164	\$ 270,836
Balances (Barbara's death)	\$ 1,297,530	\$ 333,970

Note: Assumes Barbara has drawn all income received by the SMSF, as pension payments, resulting in the overall fund balance remaining at \$1,631,500.

The balance in Barbara's account must be paid to the adult children – it cannot remain in the SMSF. Looking to the balance sheet, we note about \$31,000 in cash. If the three children are able to 'find' an average of \$101,000 each, through:

- rollovers from other funds; and/or
- personal contributions; the SMSF will have about \$334,000, enough to pay out lump sum death benefits.

Alternatively, the amount available from the children could be less, with the payments being made on a 'round robin' basis. For example, assuming the three children could rollover \$50,000 each, the following steps could occur:

Table 11:

Step	Action	Child 1	Child 2	Child 3	Balance
Initial Cash				\$31,500	
1	Rollover	\$50,000	\$50,000	\$50,000	\$181,500
2	Death Benefit	-\$60,000	-\$60,000	-\$60,000	\$1,500
	To Child	-\$50,100	-\$50,100	-\$50,100	
	Tax Withheld	-\$ 9,900	-\$9,900	-\$9,900	
3	Contribute	\$ 50,100	\$50,100	\$50,100	\$151,800
4	Death Benefit	-\$50,100	-\$50,100	-\$50,100	\$1,500
	To Child	-\$41,833	-\$41,833	-\$41,833	
	Tax Withheld	-\$8,267	-\$8,267	-\$8,267	
5	Contribute	\$41,833	\$41,833	\$41,833	\$126,999
6	Death Benefit	-\$1,223	-\$1,223	-\$1,223	\$123,330
	To Child	-\$1,021	-\$1,021	-\$1,021	
	Tax Withheld	-\$202	-\$202	-\$202	
7	Contribute	\$1,021	\$1,021	\$1,021	\$ 126,393

Because the reserve is not included as a member benefit, it does not need to be paid out of the fund, meaning the property can remain as an asset of the fund. The reserve can be gradually eroded by way of allocation to the members (i.e. the children). These allocations will not be treated as concessional contributions provided the amount allocated is:

- Distributed in a fair and reasonable manner to every member; and is
- Less than 5% of a member's account balance, each year.

The end result of the exercise is that the property has remained in the SMSF, potential capital gains tax has not been triggered, and the potential overall tax of about \$350,000 has been significantly reduced, if not eliminated in full.

Following the 'round robin' of transactions:

- Barbara's benefit will have been cleared; and
- Member accounts for the three children created.

Table 12 sets out the position at that stage.

Table 12:

Assets & Liabilities (death benefits paid out)	
Assets:	
Cash	\$ 126,392
Property	\$ 1,600,000
	\$ 1,726,392
Liabilities:	
Bank Loan	-\$ 00
Balance for Member 1	-\$ 142,954
Balance for Member 2	-\$ 142,954
Balance for Member 3	-\$ 142,954
Reserve	-\$ 1,297,530
	-\$ 1,726,392

In summary, insurance has a very important role to play when SMSFs use borrowings. Proper planning and structuring is needed to ensure that the asset acquired can be dealt with as planned, without incurring significant taxes. Together with the use of reserves and/or the other strategies mentioned in this article, the value of planning exit strategies early on can be of significant value. **FS**

Notes:

1. ATO National Tax Liaison Group (NTLG) Superannuation Technical Sub-Group minutes, Sept. 2009
2. If counted against the concessional contributions cap, the amount will not be taxed in the SMSF as an assessable contribution. Also, if the members are aged 65 or more, there is no need to meet the work test
3. 2012/13 financial year
4. Following the ATO's Draft Taxation Ruling TR 2011/D3, the Government announced it would legislate to permit assets to be disposed of within a reasonable time. Although an exposure draft of the legislation has issued, it has not yet been presented to Parliament.
5. The 2013/14 Federal Budget announced an increase of 0.5% in the Medicare levy. If passed by Parliament, the increase will be reflected in the tax rates mentioned (i.e. 16.5% will become 17%, and so on).