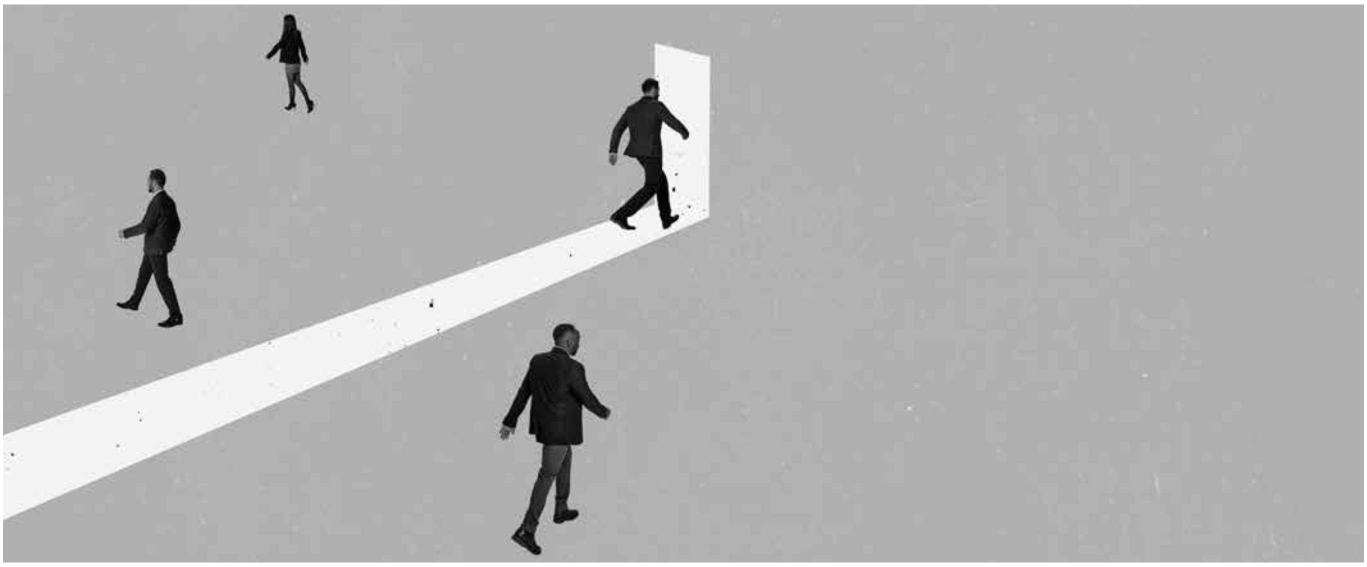

Planning the exit from an SMSF

Formulating a robust succession plan

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The first part to this paper examines key considerations that arise for SMSF members seeking to formulate a robust succession plan in relation to their SMSF benefits. There is also a focus on planning for control of a fund in different circumstances, and in particular:

- the important role for enduring powers of attorney in addressing superannuation law compliance requirements and other risks associated with a fund member losing legal capacity
- how the death of a fund member affects the control of an SMSF
- when a corporate trustee is in place, how succession to the control of the company's directorship is a critical issue that should be carefully considered.

The second part to the paper explores the tax considerations that arise in relation to paying superannuation death benefits comprising a taxable component. At the same time, options and pitfalls associated with planning to make a timely payment of benefits to a member who may not have long to live, are reviewed.

What is SMSF succession planning?

Succession planning is a critically important aspect of successfully operating an SMSF, even though it is often overlooked. Every SMSF member should develop a personal succession plan to ensure there is appropriate planning in place to govern succession to the control of the fund and other succession arrangements appropriate for their individual circumstances.

SMSF succession planning broadly aims to accomplish the following two outcomes:

- the right people receive the intended share of SMSF money and assets
- the right people have control of the SMSF to ensure that superannuation benefits are paid as intended.

An optimal SMSF succession plan should achieve these goals in a timely fashion, with minimal uncertainty and in the most tax efficient manner possible. However, it should also be recognised that trade-offs may need to be considered, as it would usually be considered preferable that the 'right' people receive a benefit and pay tax, rather than the 'wrong' people receive a benefit in a more tax efficient manner.

Accordingly, there is no easy 'one size fits all solution' for SMSF succession. However, a well thought out SMSF succession plan should ideally address the following matters:

- determine the person(s) or corporate entity who will occupy the office of trustee upon loss of capacity or death
- in relation to a corporate trustee, determine who the directors of the SMSF trustee company will be (i.e. who will have control of the company) upon loss of capacity or death of each director/member
- ensure that the SMSF can continue to meet the definition of an

SMSF under section 17A of the *Superannuation Industry (Supervision) Act 1993* (SIS Act)
- determine what each member's wishes are for their superannuation benefits
- determine to what extent each member's wishes should be 'locked in' using an automatically reversionary pension and/or a binding death benefit nomination (BDBN)
- determine the tax profile of anticipated benefits payments.

Many people have no succession plan in place for their SMSF which may result in considerable uncertainty arising in the future with respect to the control of the fund and the fate of their member benefits.

Succession on loss of capacity: Role of an enduring power of attorney (EPA)

With the passage of time, there is a significant risk that some SMSF members may lose capacity to administer their own affairs. In the absence of prior planning, this could result in major uncertainty and risk arising in relation to control of the SMSF. Having an EPA in place can help overcome this problem, as an EPA appointment is 'enduring', enabling a trusted person—the member's attorney under an EPA—to continue to run the SMSF as their legal personal representative (LPR) in the event of loss of capacity.

It is strongly recommended that every SMSF member implement an EPA as a part of their personal SMSF succession plan. It would not be an exaggeration to say that being a member of an SMSF without an EPA is courting with disaster.

Naturally, given the important responsibilities of the position, the member must trust their nominated attorney to do the right thing by them. Only a trusted person should be nominated, and in so far as the member retains capacity, the EPA should be subject to ongoing review to ensure its ongoing appropriateness.

Consideration should also be given as to whether scope of the appointment should be general in nature, in the form of a general financial power, or limited to the SMSF or to the trustee of the SMSF. For example, if the member wishes to preclude their attorney from exercising certain rights in relation to, say, their member entitlements or confirming, making or revoking their BDBN, this should be expressly covered in their EPA.

It should be noted that, by itself, an EPA is not a mechanism by which an attorney can step into the role of trustee or director of a corporate trustee. An EPA merely permits the member's attorney to occupy the office of trustee or director of the corporate trustee to help ensure the SMSF can continue to operate in a fashion consistent with the member's wishes. This is because a member's attorney appointed under an EPA is expressly recognised as satisfying the criteria relating to the trustee-member rules in section 17A of the SIS Act.

However, the attorney must still be appointed in the first place. The appointment mechanism that facilitates the LPR to step into the role of SMSF trustee or director of the corporate trustee is contained in the SMSF deed and the company's constitution. For instance, in the context of a corporate trustee, in the absence of other appointment provisions in the constitution, generally the shareholders must exercise their voting rights to appoint a director.

Succession on death: The role of the executor as LPR

The death of a member is another case where succession to control of an SMSF should be carefully considered.

Section 17A(3) of the SIS Act provides an exception to the trustee–member rules where a member has died. The exception in section 17A(3) provides that a fund does not fail to satisfy the basic conditions of the trustee–member rules by reason only that:

(a) a member of the fund has died and the legal personal representative of the member is a trustee of the fund or a director of a body corporate that is the trustee of the fund, in place of the member, during the period:

(i) beginning when the member of the fund died; and

(ii) ending when death benefits commence to be payable in respect of the member of the fund.

This exception permits an LPR of a deceased member, typically the executor of a deceased person's estate, to be an individual trustee or a director of a corporate trustee in place of a deceased member until the member's death benefits commence to be payable.

However, it is important to understand that this provision does not require or create this situation. For example, for section 17A(3) to apply, an LPR must be appointed as either:
- a director of the corporate trustee of the fund pursuant to the constitution of the company, or
- an individual trustee of the fund pursuant to the governing rules of the fund.

The operation of the provision in this way has been confirmed in numerous superannuation legal cases, particularly in *Ioppolo v Conti* [2013] WASC 389, *Ioppolo v Conti* [2015] WASCA 45 and implicitly in *Wooster v Morris* [2013] VSC 594.

These cases underscore the fact that a deceased person's LPR—their executor—does not automatically step into the role of an SMSF trustee or director upon a member's death. Broadly, it depends on the provisions of the SMSF deed. As most SMSF deeds do not have a mechanism for this to occur it will depend upon whether there are other appropriate legal documents in place to ensure this can occur.

Role of the Corporations Act 2001 in respect of corporate trustees

Section 201F of the *Corporations Act 2001* (Corporations Act) empowers the personal representatives of a sole director and sole shareholder in a private company

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to appoint new directors for the company on the death or loss of mental capacity of the principal—the sole director/shareholder.

Thus, if an SMSF comprises a sole member who is also the sole director/shareholder of the corporate trustee, section 201F can assist in relation to the member's LPR exercising powers to take control of the SMSF trustee after their death or loss of legal capacity.

However, it is important to understand the limitation of this provision. For instance, section 201F cannot assist where an SMSF member has died and an SMSF trustee company has more than one director or shareholder, or where the shareholder is a person other than the sole director who has died.

Accordingly, relying on section 201F is not a sound strategy in many cases.

Successor directors

By ensuring that the company constitution of the SMSF trustee contains successor director provisions, it is possible to plan for succession to the role of a director in a variety of circumstances without the limitations of:

- appointing a new director via the usual rules in the corporate trustee's constitution (e.g. by majority shareholder vote)
- the limited flexibility in section 201F of the Corporations Act.

Making a successor director nomination allows a director to nominate a person to automatically step into the shoes of the principal's directorship role immediately upon loss of capacity, death or another specified event occurring.

The successor director strategy is designed to work in conjunction with a member's overall estate and succession plan to enable an attorney appointed under an EPA or an executor of a deceased member's will to be automatically appointed as a director without any further steps involved.

Naturally, a successor director strategy relies on the right paperwork being in place, including the right constitution and related successor director nomination form.

Tax considerations on death

The tax profile of death benefits is also a relevant consideration in succession planning.

Where a death benefit is paid to a tax dependant — by definition a death benefit dependant under section 302-195 of *Income Tax Assessment Act 1997* (ITAA 1997) — the dependant generally receives the benefit tax free regardless of any taxable component that forms part of that payment.

A tax dependant means any of the following:

- the deceased person's spouse or former spouse
- the deceased person's child, aged less than 18 at the time of death
- any person with whom the person has an interdependency relationship
- any other person who was a dependant of the deceased person just before he/ she died. *

* Note. This limb of the definition imports the common law meaning of dependant, which is accepted to include financial dependency.

Accordingly, adult independent children do not generally qualify as death benefit dependants. Thus, the taxable component of any death benefit payment they receive—usually when there is no surviving spouse—will be subject to a 'death tax' of typically 15% plus the 2% Medicare levy. Only the tax-free component is tax free.

When it is considered that the average SMSF holds over $1 million in assets, the tax exposure of benefit payments made to adult independent children is likely to be significant.

Taxation on a lump sum payment of death benefits

Table 1 provides a summary of the tax applicable on lump sum superannuation death benefit payments.

Table 1. Taxation of death benefits paid as a lump sum

	Tax free component	Taxable component (element taxed in the fund)	Taxable component (element untaxed* in the fund)
Tax dependant	Not included in recipient's assessable income	Not included in recipient's assessable income	Not included in recipient's assessable income
Non-tax dependant	Not included in recipient's assessable income	Included in recipient's assessable income but the recipient is entitled to tax offset that ensures that the rate of income tax does not exceed 15%	Included in recipient's assessable income but the recipient is entitled to tax offset that ensures that the rate of income tax does not exceed 30%
		Rates exclude Medicare levy, currently 2%.	

* Generally, there is no element untaxed in an SMSF. The one exception is where insurance is involved. Section 307-290 of the Income Tax Assessment Act 1997 (ITAA 1997) can operate to make a superannuation death benefit that is paid as a lump sum partly consist of an element untaxed, if the fund has previously claimed deductions for life insurance premiums in respect of members. However, the element untaxed from an SMSF has no practical effect if it is received by a tax dependant or if the deceased attained age 65 or over prior to their death.

Planning for an exit

Given the impact of the above effective death tax on death benefits paid to adult independent children, one option that some members consider is planning to withdraw their superannuation benefits before they die. Naturally, one never knows the 'hour nor the minute' of when death may strike. However, statistics suggest that most people have some warning before they pass away.

Under current taxation rules, provided the member is over age 60 and has met a full condition of release, for example retirement or attaining age 65, their benefits can be withdrawn from the superannuation environment tax-free. Given superannuation is concessionally taxed, money invested outside superannuation is generally not as tax efficient.

However, relying on a 'withdraw before you die' approach is not always a straightforward exercise as the member and SMSF trustee may need time to:

- pay required pro-rated minimum payments in respect of any pensions that are in place that will be commuted as part of a withdrawal
- commute one or more pensions prior to paying any lump sums
- sell-off fund assets to obtain liquidity (e.g. in relation to pension payments)
- transfer assets in specie (i.e. as part of a pension commutation or a lump sum payment from accumulation phase benefits).

Thus, hoping for a quick exit in the future can be subject to several hurdles given that the hour or minute of our death cannot be accurately predicted.

Importantly, such an exit plan based on there being ample time to withdraw a superannuation benefit is vulnerable due to the numerous hurdles that could result in such a strategy easily failing. For example, if the member loses mental capacity to make a decision, or otherwise is physically incapacitated due to rapidly deteriorating health, achieving a timely exit may not be possible in the time available.

Some suggest that appointing an attorney under an EPA can be used to overcome these issues, however, this proposed solution is not that simple.

Risks associated with relying on attorneys under an EPA and why the SMSF trustee is placed to implement an exit plan.

Some individuals seek to rely on a spouse or close family member, trusted friend or adviser to withdraw their benefit pursuant to an EPA at the appropriate time.

However, relying on an EPA in this situation involves a few risks including:

- The legislation governing EPAs differs between each state and territory and only the Tasmanian power of attorney legislation contains express language empowering an attorney to deal with a person's superannuation interest(s). Therefore, it is recommended that any EPA documentation contain express authority to deal with superannuation.
- Without an SMSF deed expressly authorising an attorney under an EPA to act for a member, the EPA might not be effective. This may be the case in relation to the attorney exercising a member's rights and entitlements under an SMSF deed, as an SMSF is a form of trust and an EPA does not authorise an attorney under a trust as the trust deed is the relevant document that governs the rights and obligations under the trust.
- An attorney withdrawing a member's benefit may not be acting in the donor/principal's best interests if others (including the attorney) are attempting to benefit from the withdrawal. Indeed, the situation might give rise to a conflict unless the EPA contains appropriate wording authorising an attorney to act (i.e. based on it being permitted conflict).

Additionally, it is important to note that there is a difference between an attorney seeking to exercise membership rights and entitlements under an SMSF deed, and valid legal decisions being implemented at the trustee-level.

For instance, even if there is complete confidence in the attorney being authorised to deal with membership rights and entitlements, and assuming there is no conflict, there is still the question of properly implementing a timely payment at the trustee-level.

As already noted, there are various steps that must generally be implemented by the SMSF trustee as part of an exit strategy, such as:

- payment of a lump sum from an accumulation interest
- payment of the member's required minimum pension payments in cash
- commutation (in part or in full) of a pension interest and payment of the commuted amount outside of the superannuation environment (i.e. as a lump sum)
- where assets are being transferred in specie, signing applicable transfer forms and updating legal registers in relation to ownership changes.

Timely and legally effective decision-making by the trustee

Although it is readily accepted that having an EPA is critical for SMSF succession planning, robust exit planning should also ideally focus on timely and legally effective decision-making at the trustee-level.

After all, it is the trustee who holds legal title to the fund's assets, and it is the trustee who must uphold and comply with the terms of the trust deed and comply with the payment standards in relation to voluntary cashing of benefits under the *Superannuation Industry (Supervision) Regulations 1994*. An attorney who is not a trustee/director cannot generally control this process.

Thus, a robust exit plan generally requires putting in place appropriate succession planning arrangements which ensure that the SMSF trustee—generally this should be a special purpose company—is always able to

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make timely and legally effective decisions at the appropriate time. For instance, a sound succession plan should always include a clear path for the member's attorney under an EPA to become a director of the SMSF trustee in place of a member who cannot act or who has lost mental capacity.

This kind of planning is not just relevant for making a timely payment of benefit as part of an exit strategy. It is also critical to helping ensure that a fund continues to meet the definition of an SMSF in section 17A of the SIS Act when a member can no longer act as a trustee/director, for example due to being incapacitated.

Conclusion

This paper initially focused on some of the key ingredients for successful SMSF succession planning, including how to plan for control of a fund in the context of death and loss of mental capacity.

It then examined the tax considerations associated with payment of superannuation death benefits, and some options and pitfalls associated with planning to make a timely payment of benefits to a member who may not have long to live.

As can be appreciated there is no easy 'one size fits all solution' for SMSF succession.

The intention of this paper is to inform readers of some general considerations that should be taken into account as part of formulating a robust SMSF succession plan. **FS**