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SMSF, REAL PROPERTY AND DEATH

Yvonne Chu

The ability to invest directly in real properties (commercial or residential) is often one of the main reasons that clients decide to establish a self-managed superannuation fund (SMSF). The possibility of leasing a business real property (BRP) to the members or a related party of the SMSF compounds the appeal of the strategy. Some clients would take advantage of this by entering into a limited recourse borrowing arrangement to facilitate the acquisition.

However, it is important for SMSF trustees (clients) to consider what will happen to the illiquid real property should the inevitable happen—when a member of the fund dies.

The death of a member could prompt a fund trustee to sell a large illiquid asset such as a real property to fund a lump sum death benefit payment. This may result in a trustee:

- losing control of an asset that might be used in a related party's business,
- selling an asset at an unfavourable time in the investment cycle,
- incurring expensive valuation and transaction costs, or
- triggering a capital gains tax event and realising capital gains or capital losses.

The surviving members of the SMSF may also prefer to retain assets such as a BRP within the fund to keep the asset in a concessionally taxed environment.

What are the SIS and tax requirements following death?

SIS requirements

Following the death of a member, it is compulsory for the trustees of the SMSF to 'cash' as soon as practicable a member's benefits in the fund[1] after the member passes away. The death benefits can be cashed in any or more of the following forms to beneficiary who is a dependant[2] of the deceased at the time of the death:

- a single lump sum; or
- an interim lump sum and a final lump sum; or
- one or more pensions or annuities, each of which is a superannuation income stream that is in the retirement phase.

If the beneficiary is a child of the deceased member, then the child must be either under 18 years of age, or under 25 years of age and financially dependent or has a severe disability before a death benefit income stream can be paid to them.

Tax implications

When making a lump sum death benefit payment to a non-dependant for tax purposes[3] (excluding the Legal Personal Representative (LPR) of the deceased), the trustee must withhold death benefit tax at a rate of 17% (including Medicare Levy) on the taxed element and 32% (including Medicare Levy) on the taxable component (untaxed element). No tax needs to be withheld if the lump sum is paid to a tax dependant or to the deceased's LPR.

The quote

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Where the lump sum is paid to the LPR it forms part of the deceased's estate and the LPR is responsible for distributing the lump sum in accordance with the terms of the will or state-based intestacy law. When paying the death benefit to a non-dependant for tax purposes, the LPR is also responsible for including the taxable component in the assessable income for the estate. The maximum tax the estate will pay is 15% on taxable component (taxed element) and 30% on taxable component (untaxed element). The net amount that is then distributed to a non-dependant beneficiary for tax purposes will be non-assessable non-exempt income of the beneficiary.

If the SMSF trustee is paying a death benefit income stream to a beneficiary, trustees generally only need to withhold tax if the pension payments contain a taxable component and both the deceased at the time of death and the beneficiary are under 60 years of age.[4]

Keeping an illiquid asset in the SMSF following death

Death benefit income stream

The most straightforward way for the trustee of a SMSF to retain an illiquid asset in the SMSF is to pay the deceased's benefits in the form of a death benefit income stream.

As part of the superannuation changes that came into effect on 1 July 2017, death benefits must be cashed either as a lump sum or used to commence one or more superannuation income stream that is in retirement phase. Effectively, a death benefit income stream would count towards the beneficiary's, typically a surviving spouse, transfer balance cap. Where the death benefit amount exceeds the beneficiary's personal transfer balance cap, the excess must be commuted out of the superannuation system.

For those beneficiaries who are already in receipt of a superannuation income stream and have used up some or all of their personal transfer balance cap (TBC), they may not be able to take much of the death benefit as an income stream, if at all.

A potential strategy that will allow more funds to be retained in the superannuation environment (SMSF) is for the beneficiary to commute and rollover a retirement phase income stream in their own name to accumulation phase to 'free-up' TBC space. However, at times, due to the limitation imposed by the TBC, part of the death benefit may have to be paid as a lump sum out of the SMSF.

Case study

Betsy and Francis are both 75 years of age and members of the Brown Family Super Fund. Prior to retirement Francis was a small business owner. When he sold his business to his son James, he took advantage of the small business CGT cap and made a larger contribution into super using the sale proceeds. As a result his balance is a lot higher than his wife Betsy.

Following the introduction of the transfer balance cap, Francis had to roll a substantial amount of his account based pension back to the accumulation phase.

Member account details on 1 July 2017

Account type	Member	Amount
Account-based pension	Francis	$1,600,000
Accumulation phase	Francis	$1,000,000
Account-based pension	Betsy	$600,000
Total		**$3,200,000**

The Brown Family SMSF owns a business real property that is currently leased to James' business on commercial terms. The market value of the BRP is $1.8 million. The remainder of the SMSF assets is invested in direct equities, managed funds and cash accounts.

Sadly, Francis passed away on 1 January 2019. Francis had a valid binding death nomination leaving his entire superannuation interest in the SMSF to Betsy. The member account details of the SMSF at the time of death are as follows:

Account type	Member	Amount
Account-based pension	Francis	$1,500,000
Accumulation phase	Francis	$1,000,000
Account-based pension	Betsy	$550,000
Total		**$3,050,000**

Francis' total superannuation benefits at the time of death is $2.5 million which needs to be paid to Betsy as soon as practicable. As Betsy has already used up $600,000 of her TBC, if she does nothing, she'll only be able to commence a death benefit income stream of $1 million and the remaining $1.5 million must be paid to her as a lump sum. Alternatively, if Betsy rolls her own account based pension back to accumulation phase, she'll free-up $550,000 of her TBC and will be able to commence a death benefit income stream of $1.55 million. Only $950,000 of the death benefit needs to be paid out of the SMSF to Betsy as a lump sum death benefit payment.

Most importantly, the Brown Family Super Fund will be able to retain the BRP in the SMSF.

Other considerations for paying death benefit income streams

The SMSF must ensure it has sufficient cashflow to meet ongoing pension payments. An income stream ceased to be a retirement phase income stream for tax purposes (which means it'll lose its tax exemption) if it doesn't satisfy the minimum pension payment standard. Additionally, if a death benefit income stream fails this requirement it could result in the compulsory cashing of

the amounts supporting the income stream as death benefits must be retained in retirement phase at all times and cannot be rolled into accumulation phase. This is an issue the trustee must address if the income from the asset, such as rent, is inadequate to meet the required pension payments. It will become even more prevalent as the beneficiary ages as the minimum pension payment requirement increase with age. Overtime, trustees may still have to dispose assets held by the fund to satisfy this requirement.

If the beneficiary is not an existing member of the SMSF they will need to become a member and trustee or a director of the trustee company of the SMSF in order to receive an income stream.

Where beneficiaries are adult non-dependent children

Unless an adult-child of the deceased has severe disability, death benefits cannot be paid in the form of a death benefit income stream. The question of whether a real property can be kept in an SMSF where the beneficiaries are all non-dependent adult children comes up often. It may be possible to retain a real property or any other illiquid asset within the fund if the non-dependent child can make contributions to the SMSF of an amount equal to the lump sum death benefit payment (taking into account concessional and non-concessional contributions caps). The SMSF trustee could then use the cash contributed by the non-dependent adult child to pay the lump sum death benefit. The adult child would become a member of the SMSF (if not already one).

Matters that trustees will need to be mindful of when considering this strategy include:

- The SMSF trust deed must allow the dependant to become a member/trustee of the fund and to make contributions to the fund. The beneficiary must be eligible to make a contribution to super and be mindful of relevant caps.
- The beneficiary must have sufficient financial means to make the necessary contributions. If the beneficiary is going to take out a short-term loan to finance the contributions, the cost of borrowing would not be tax deductible.[5]

Trustees will also need to consider all other regulatory requirements such as investment strategy and asset allocation when admitting a new member.

If the asset can't be retained in the SMSF, does it have to be sold on the market?

Where a lump sum death benefit must be paid and the SMSF trustee cannot avoid having to dispose of the asset, the trustee could consider paying an in-specie death benefit rather than selling the asset on the market and pay out the proceeds. This may be preferred by the beneficiary as it allows the beneficiary to continue to control the asset (which may be important where the BRP is being leased to the beneficiary's business). Although there are restrictions when it comes to an SMSF acquiring an asset from a related party, there are no reciprocal restrictions on an SMSF disposing of an asset to an SMSF (except in the case of personal use/collectible assets) other than it must be on market value terms.

In the event that only a portion of the asset is required to fund the lump sum death benefit (e.g. where the fund's assets consist of a single property and the deceased's entitlement accounts for a portion of its value) it is possible for the fund to transfer an interest in the asset to the beneficiary at market value. The beneficiary would then hold the asset as tenants in common with the SMSF with any future income and eventual sale proceeds split in line with the relevant ownership percentages.

When making an in-specie lump sum death benefit payment, trustees and beneficiaries need to consider:

- Capital gains tax implications: a CGT event occurs for the SMSF when transferring an asset in-specie to a beneficiary as there is a change in the beneficial and legal ownership of the asset. If the asset that is transferred is not wholly supporting a current or contingent liability to pay a pension, all or part of any net capital gains on the disposal will be included in the SMSF's assessable income for the year.
- Trustees with most of their SMSF's assets concentrated in illiquid assets need to consider the liquidity requirements of the fund when it is time to pay the CGT liability or remit any death benefit tax withheld to the ATO.
- All dealings must be on arm's length terms.
- All transactions must be at market value.
- Beneficiary may have to pay stamp duty on the transfer of the asset and should refer to their relevant State Revenue Office for further details
- Whether the trust deed restricts any in-specie payments to be made. FS

Notes

1. Superannuation Industry (Supervision) Regulations 1994 sub-regulation 6.21(1).

2. Dependant is defined in section 10 of the SIS Act and includes the spouse of the person, any child of the person and any person with whom the person has an interdependency relationship. Note the legal personal representative of the deceased member can also be paid a lump sum death benefit.

3. The meaning of 'dependant' in the Income Tax Assessment Act 1997 (ITAA) is defined differently to the SIS Act. Under section 302-195 of ITAA, a 'dependant' is the deceased's spouse, former spouse, child aged less than 18, anyone with whom the deceased had an interdependency relationship, or a dependant of the deceased at the time of death.

4. In the rare event that the SMSF trustee is paying a reversionary capped defined benefit income stream to someone aged 60, there could be a PAYG withholding requirement.

5. ATO ID 2001/257, section 26-80 of ITAA 1997