Sladen Legal

SMSFs and Real Estate Upon the Death of a Survivor

TEN Webinar – 26 November 2014

Reference: 1PJB: 21302414

Written and presented by:

Phil Broderick
Principal
Sladen Legal

Sladen Legal
Level 5, 707 Collins Street
Melbourne 3008
Victoria Australia

DX 30970
Stock Exchange

PO Box 633
Collins Street West
Victoria 8007

T +61 3 9620 9399
F +61 3 9620 9288

sladen.com.au

INTRODUCTION

A typical SMSF[1] being the classic "mum and dad" SMSF, generally transitions pretty smoothly through the lifecycle of its members. This includes the accumulation of assets in the growth/accumulation stage and managing benefit payments through the pension stage. It also generally transitions smoothly on the death of the first with the ability to pay a death pension to the survivor.

However, there is one event that can create significant transition issues for SMSFs: being the death of the surviving spouse, particularly in instances where the fund holds lumpy assets such as real estate. In this paper I have concentrated on this particular event, and will analyse the issues, what to do and how to plan for the death of a surviving spouse where most of the assets of the SMSF are real estate.

Legislative references used in this paper include the *Superannuation (Industry) Supervision Act 1993* (Cth) (**SIS Act**), the *Superannuation (Industry) Supervision Regulations 1994* (Cth) (**SIS Regs**), the *Income Tax Assessment Act 1997* (Cth) (**ITAA97**), and the *Income Tax Assessment Regulations 1997* (Cth) (**ITAR97**).

WHAT IS THE PROBLEM?

The key issue facing SMSFs is that generally, upon the death of the surviving spouse, there is no one to whom a death benefit pension can be paid. In this instance, the survivor's benefits (and assets of the SMSF equal to those benefits) must be paid out to the survivor's 'SIS dependants' or legal personal representative.[2]

This can create issues when the SMSF has lumpy assets such as real estate, including:

- the tax consequences of dealing with the asset;
- whether the asset has to be sold;
- the duty and GST issues of transferring the asset to SIS dependants or the legal personal representatives; and
- dealing with outstanding borrowings (under limited recourse borrowing arrangements (**LRBA**s)).

PRELIMINARY CONSIDERATIONS – WHO CAN RECEIVE DEATH BENEFITS AND HOW WILL THEY BE TAXED?

Before I launch in to considering the above issues, I will briefly outline three important preliminary issues; namely, who can receive the death benefits on the death of the surviving spouse, in what form the benefit can be paid, and how the death benefits will be taxed.

Who can receive death benefits?

It is important to note that under regulation 6.22(2) of the SIS Regs, death benefits can be paid to a 'dependant' of the member or the member's legal personal representative (**LPR**).

'Dependant' is defined in section 10(1) of the SIS Act to include the spouse of the member, any child of the member, and any person with whom the member has an interdependency relationship (**SIS Dependant**).[3] As an inclusive definition, an SIS Dependant will also include other persons who are financially dependent on the member at the date of the member's death.

---

[1] In this paper the reference to SMSFs includes, where the context requires, the trustees of SMSFs in their role as trustees of SMSFs.
[2] SIS Regs reg 6.21.
[3] Interdependency relationships are defined in s 10A(1) of the SIS Act.

An LPR is relevantly defined to include the executor of the will or administrator of the estate of a deceased person.

In what form can death benefits be paid?

Death benefits can be paid either in the form of a lump sum or in the form of a pension. While lump sums can be paid to anyone who can receive death benefits, pensions, on the other hand, cannot be paid to the estate or adult children who are not financially dependent on the deceased at the time of the deceased's death.

Children can receive a death benefit pension if they are under 18, or if they are aged between 18 and 25 and were financially dependent on the deceased at the time of the deceased's death, or if they otherwise suffer from a disability. In relation to non-disabled children, the death benefit pension must be commuted on or before they turn 25, at which time the balance of the pension account must be paid as a lump sum to the child.

How will death benefits be taxed?

The taxation of death benefits depends primarily on whether the recipient is a 'death benefits dependant', and in what form of the death benefit will be paid (i.e. as a pension or lump sum).

A 'death benefits dependant' is defined in the ITAA97 as:[4]

- the deceased person's spouse or former spouse; or
- the deceased person's child, aged less than 18; or
- any other person with whom the deceased person had an interdependency relationship just before he or she died; or
- any other person who was a dependant of the deceased person just before he or she died; or
- the payment to any person as a result of the member (who is a member of the defence forces or police) dying in the line of duty.

The following tables show there is a strong tax incentive to pay death benefits to a death benefits dependant:

Table 1 - Taxation of lump sum death benefits

	Tax free component	Taxable component (taxed in the fund)	Taxable component not taxed in the fund[5]
Death Benefit Dependants	Nil	Nil	Nil
Non-Death Benefit Dependants	Nil	Up to 16.5%	Up to 31.5%

[4] s 302-195 ITAA97
[5] For example, life insurance proceeds.

Table 2 - Taxation of pension death benefits (only payable to death benefits dependants)

	Tax free component	Taxable component (taxed in the fund)	Taxable component not taxed in the fund
Either deceased or dependant 60+	Nil	Nil	Included in assessable income with a 10% rebate
Neither deceased nor dependant 60+	Nil	Included in assessable income with a 15% rebate	Included in assessable income

DOES A PENSION CEASE UPON THE DEATH OF THE SURVIVING SPOUSE AND WHAT ARE THE TAX CONSEQUENCES TO THE SMSF

The payment of a death benefit itself does not cause any direct tax consequences to the SMSF, but the form of the death benefit can have tax consequences to the fund.

For example, a death benefit that is paid in the form of a pension will result in the assets supporting that pension not being subject to taxation (if a segregated method is used) or that a pro-rata tax exemption will apply to the assets of the fund (if a non-segregated method is used). However, once a lump sum death benefit is paid to a beneficiary, any investments made with the benefit outside of super will be subject to tax in the ordinary way (the tax treatment of which will depend on whether the assets are invested in the name of the beneficiary, another person or another entity).

Until recently, where the member had a pension interest at the time of their death there was a tax incentive that favoured reversionary pensions over other non-reversionary death benefits. This was on the basis of the ATO's view that, absent a reversionary pension, a pension will cease upon death and therefore the super fund would go from 'pension phase' to 'accumulation phase'.[6] The consequence of this view was that assets realised after the death of a pensioner, without a nominated reversionary pensioner, would potentially trigger capital gains tax.

This issue has now been remedied by legislation, with the result that pension phase will now continue after the death of the pensioner even if the death benefit is paid as a lump sum.[7] This is provided that the death benefit is paid out "as soon as practicable".

The only remaining difference between the tax treatment of reversionary pensions and non-reversionary death benefits is the treatment of insurance proceeds and anti-detriment payments. In the case of reversionary pensions, for such amounts forming part of the reversionary pension the taxable/tax free components will match the existing ratio for the reversionary pension. However for non-reversionary death benefits, such amounts are added to the taxable component.[8]

For a more detailed discussion in relation to the payment of pensions, reversionary pensions and binding death benefit nominations see my paper, 'Binding Death Benefit Nominations and Reversionary Pensions. - http://sladen.com.au/news/2014/3/31/binding-death-benefit-nominations-and-reversionary-pensions

[6] Australian Taxation Office, *Income tax: when a superannuation income stream commences and ceases*, TR 2013/5, 31 July 2013.
[7] reg 307-125.02 ITAR97 and the definition of superannuation income stream benefit in reg 995-1.01(2).
[8] reg 307-125.02 ITAR97

WHAT OPTIONS ARE AVAILABLE TO AN SMSF TO PAY DEATH BENEFITS WITH A LUMPY ASSET SUCH AS REAL ESTATE?

On the death of the surviving spouse there will generally be up to three possibilities in relation to the payment of death benefits:

- there are minor children or children aged between 18 and 25 who are financially dependent on the survivor upon the survivor's death or disabled children who can receive a pension benefit;
- there are other persons who are financially dependent on the survivor at the time of the member's death; or
- there are no persons who can receive death benefits and therefore the benefits must be paid as a lump sum (eg to adult children or the estate).

Option 1 - Paying pensions to children

This option is only available if a child is aged less than 18, aged between 18 and 25 and financially dependent on the deceased at the time of their death or disabled. For children who don't meet any of these criteria, only option 3 is available.

This option has the advantages that:

- the real estate can stay in the SMSF until the pension is commuted;
- the pension payments will be tax free or taxed concessionally; and
- the income in the SMSF will be tax free to the extent of the pensions.

However this option also presents a number of disadvantages, including that:

- the pensions have to be commuted when the child turns 25 (unless the child is disabled) and therefore provides only a temporary solution to not having to deal with the real estate;
- the minimum pension payments will need to be paid and there is no ability to fix these liquidity by commuting the death benefit back into an accumulation account;
- the children will be given access to the assets at the age of 25 raising issues in relation to asset protection (e.g. bankruptcy or family law claims against child) and whether it is appropriate to give large gifts to the child (e.g. if they a spendthrift or have gambling or drug issues);
- if the real estate ends up in the hands of the children there could be tax and duty consequences for moving the real estate into a better structure (e.g. a discretionary trust); and
- the interest in the SMSF is not protected from family law claims by spouses of the children.

Option 2 - Paying pensions to other financial dependants

This option has the same advantages as the first option but without the first four disadvantages. This is because the payment of a death benefit pension to a financial dependant (or interdependent) who is not a child does not need to be commuted.

The biggest problem with this option is that, on the death of the survivor, there will often not be anyone who is dependant or interdependent on the surviving spouse. Therefore, this option will often not be available.

Option 3 - Paying lump sums to children or the legal personal representative

This option is often the only one available on the death of the surviving spouse. However, even if the first two options are available, this option may nevertheless be preferred because:

- the surviving spouse doesn't want the children to receive a lump sum benefit when they turn 25; or

- the benefits will be paid to the estate (for example to form part of the testamentary trusts established under the survivor's will).

There are a number of ways in which the lump sum can be effected. These are discussed below.

WHAT OPTIONS ARE AVAILABLE FOR DEALING WITH THE REAL ESTATE FOR THE PAYMENT OF LUMP SUMS?

Broadly, the SMSF has three options for paying a lump sum death benefit where it holds real estate:

- sell the real estate and use the proceeds to pay the lump sum;
- transfer the real estate as an in-specie lump sum death benefit; or
- contribute cash into the SMSF to fund the lump sum and leave the real estate in the SMSF.

Each of these options are discussed below:

Option 1 -Sell the real estate

This option may be used where the beneficiaries of the lump sum did not want the real estate and would prefer a cash payment, or where one of the beneficiaries wants the real estate while one or more of the others do not, and the SMSF does not hold enough liquid assets to pay out the others.

The tax treatment of the sale will depend on whether the surviving spouse was receiving a pension at the time of their death. If they were not, then the sale will be subject to capital gains tax at the rate of 10% or 15%. If they were receiving a pension then, as noted above, the SMSF will stay in pension phase provided the lump sum is paid as soon as practicable.

Option 2 - Transfer the real estate as an in-specie benefit

This option may be used if the beneficiaries wish to retain the real estate and either the third option is not available or the beneficiaries wish to hold the property outside of super. Reasons for holding the real estate outside of super include the ability to charge the real estate or use it without the restrictions that come with holding real estate in SMSFs.

It's important to note that the real estate cannot be transferred as an in-specie pension benefit. As a result, if there is a reversionary pension payable, the pension would have to be commuted in whole or part to transfer the real estate as an in-specie lump sum.

The in-specie transfer of the real estate will trigger the application of the capital gains tax provisions with the capital proceeds being equal to the market value of the real estate at the time of the transfer. Whether capital gains tax will be triggered will depend on whether the surviving spouse was receiving a pension at the time of his or her death as discussed for the first option.

The potential application of duty must also be considered. In relation to the duty exemption in Victoria,[9] there is some uncertainty as to its application on the basis of the requirement that the recipient of the transfer be a beneficiary of the SMSF at the time the real estate was acquired by the SMSF. The Victorian State Revenue Office generally takes the view that this does not extend to non-member beneficiaries unless a binding death benefit nomination has been made in favour of that non-member beneficiary before the SMSF acquired the property.

Exemptions are also available in other states. I am not an expert in duty laws outside of Victoria and therefore a local duties expert's advice should be obtained in relation to the exemptions available to that State. That said, I note that there is an express exemption for transfers from SMSFs to SIS Dependants and LPRs in the Western Australian Duties Act[10] and restricted exemptions for transfers to beneficiaries of trusts in New South Wales[11] and Queensland.[12]

---

[9] *Duties Act 2000* (Vic) s 41A.
[10] *Duties Act 2008* (WA) s 127.
[11] *Duties Act 1997* (NSW) s 57.
[12] *Duties Act 2001* (Qld) s 123.

GST must be also considered where the real estate is a non-residential property and the SMSF is registered for GST. Considerations include:

- whether the transfer a 'taxable supply';
- whether any exemptions apply (e.g. going concern or farm land);
- whether any applicable GST can be claimed back by the beneficiary or the LPR (i.e. if they are registered for GST); and
- whether the beneficiary can register for GST (i.e. are they carrying on an enterprise).

Option 3 - Contribute cash into the SMSF

Under this option the beneficiaries contribute or rollover cash into the SMSF sufficient to pay the lump sum death benefit. Of course, this is subject to the beneficiaries being able to make sufficient contributions (under their contribution caps) and rollovers.

The following is an example of this option. Bill, the sole member of his SMSF, dies. The SMSF holds $1 million of assets comprised of $200K in cash and an $800K commercial property. Bill has two adult children Chris and Karen, both of whom would prefer to keep the real estate in the SMSF. They therefore each make a $400K non-concessional contribution to the SMSF. The SMSF then uses its cash of $1 million to pay Chris and Karen a lump sum benefit of $500K each. The commercial property will then be retained in the SMSF for the benefit of Chris and Karen.

As the real estate will be retained in the SMSF, there are no issues created from the transfer or sale of the real estate (including the tax, GST and duty issues). There are also potential savings from not having to deal with the property (e.g. sale costs and legal fees), and the advantages that come from holding the real estate in an SMSF (e.g. tax savings).

ISSUES ARISING WHEN A LRBA IS INVOLVED

Where at the time of the death of the surviving spouse there is an outstanding LRBA loan, additional issues and complexities may arise.

The main issue is that generally on the death of the surviving spouse the LRBA loan must be repaid. This may be because there is an express term in the LRBA loan documentation to that effect, or it may be because the assets of the SMSF must be realised/transferred to pay a lump sum death benefit (which cannot occur until the loan is repaid).

The repayment of the LRBA loan could be effected by:

- selling the real estate;
- using other cash in the SMSF (if any);
- contributing/rolling over cash into the SMSF;
- use of insurance proceeds in the SMSF;
- use of insurance proceeds outside of the SMSF; or
- assigning the loan to the beneficiary with the real estate.

Alternatively, the real estate could be left in the SMSF (as discussed above) and the beneficiaries could "take over" the LRBA loan.

As variations of the first three options are discussed above, the following will review the last three options:

Option 4 - Use of life insurance in the SMSF

Life insurance in the SMSF could be used in 3 ways:

1. Allocated to the surviving spouse's account

This option generally does not help with the liquidity issue as it enlarges the amount of death benefits that must be paid.

2. Allocated under a 'cross insurance' model, for example if a beneficiary was also a member

The problem with this option is the application of reg 4.07D(2) of the SIS Regs, which provides:[13]

> [An SMSF] must not provide an insured benefit in relation to a member of the fund unless the insured event is consistent with a condition of release specified in item 102, 102A, 103 or 109 of Schedule 1.

The ATO takes the view that this regulation prevents cross insurance arrangements.

Although it should be noted that the regulation only applies to insurance obtained from 1 July 2014. Pre-1 July 2014 cross insurance arrangements are grandfathered

3. Allocated to a reserve account

Regulation 4.07D(2) only applies to 'insured benefits'. An insured benefit is defined in the SIS Regs to mean "for a member, means a right, other than an anti-detriment payment, for the member's benefits to be increased on the realisation of a risk".[14] This definition would not appear to apply directly to an allocation to a reserve. There is uncertainty as to whether the ATO would argue that it could apply indirectly given that the insured amount could then be allocated from the reserve to the member account.

Another issue is whether an allocation from a reserve to a member account can be treated as a concessional contribution.[15] There is a limited exemption that applies where the amount is allocated to each member (or each member in a class) and is less than 5% of the member's interest in the super fund. However, if the loan is paid out directly from the reserve account (and no amount is allocated to another account), then the regulations appear not to treat the loan repayment as a contribution.

Option 5 – Holding life insurance outside of super

Given the restrictions and complexities of holding life insurance in an SMSF, another option is to hold life insurance outside of super. For example, the surviving spouse has insurance over him/her and the proceeds used by the beneficiaries to make contributions to the SMSF which in turn are used to repay the LRBA loan (and potentially fund the lump sum death benefit).

Issues that arise out of this option include:

- the application of contribution caps – especially where the loan and/or the value of the real estate is large so that it is not possible to contribute enough to;
- whether insurance can be obtained over the surviving spouse – the surviving spouse may not be able to get insurance due to age or illness; and
- the life insurance will not be deductible (as it may be if it's held in the SMSF).

Option 6 – Assigning the loan to the beneficiary with the real estate

Under this option the beneficiary agrees to assume the liabilities of the LRBA loan in consideration of receiving an in-specie lump sum transfer of the real estate. The end result is similar to lump sum in-specie transfer option, except the beneficiary assumes the loan with the real estate.

This option is only likely to be available where the lender is a related party (as a bank is unlikely to agree to such an arrangement).

Given that under an LRBA the real estate must be held by a holding trust there are additional considerations for the transfer of the real estate from the holding trust to the SMSF that must be

[13] This regulation applies only to insurance obtained from 1 July 2014. Pre-1 July 2014 cross insurance arrangements are grandfathered.
[14] SIS Regs reg 4.07C.
[15] ITAA97 s 291-25(3), and ITAR97 reg 292-25.01.

considered (in addition to the issues that arise from the transfer from the SMSF to the to the beneficiary – as discussed above). These holding trust issues include:

- Duty;
- CGT;
- GST.

For a discussion of these issues, and other issues relating to LRBAs see my paper 'An A to Z of Limited Recourse Borrowing Arrangements' http://sladen.com.au/news/2014/3/31/an-a-to-z-of-limited-recourse-borrowing-arrangements.

* * * * * * *