SuperConcepts

Death – What happens next?

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December 2021

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Agenda

- SMSFs post death
- Timeframes of and re-structuring
- Capital Gains Tax on paying death benefits
- The importance of separate superannuation interests
- Non-reversionary pension ECPI post death
- Paying lumpy assets as death benefits.

Abbreviations

ATE – Assets Test Exempt

ABP – Account Based Pension

BDBN – Binding Death Benefit Nomination

CC – Concessional Contribution

ECPI – Exempt Current Pension Income

EPOA – Enduring Power of Attorney

LPR – Legal Personal Representative

MLP – Market Linked Pension

NCC – Non Concessional Contribution

NOI – Notice of Intent

OMT – Off Market Transfer

TBA – Transfer Balance Account

TBAR – Transfer Balance Account Reporting

TBC – Transfer Balance Cap

TSB – Total Super Balance.

SMSF post death

- When a member dies, their benefit must be ‘cashed’
- This can be as a pension, lump sum, or combination of the two
  - Depends on the status of the beneficiary
- The deceased also ceases to be a member and trustee, or director of the corporate trustee
- So THREE things must happen:
  - Their benefit must be ‘cashed’
  - They must be removed as member
  - They must be removed as trustee.

Timeframes and re-structuring

- When an *individual* ceases to be a trustee due to death:
  - The fund trusteeship must be re-structured within 6 months from the date of death
  - This means appointing another individual trustee
  - Or appointing a company as trustee
  - Resignation and appointment documents must be completed (new Trustee Declaration must be signed)
  - Register all existing assets in the name of the new individual trustees or company trustee.
- If the fund is going to be wound up within 6 months from date of death, then may not need to appoint new trustee if surviving spouse is LPR of deceased
- If the fund is going to be wound up beyond 6 months, then best practice is to appoint a new trustee (whether individual or company)
- If director ceases to be so due to death:
  - Notify ASIC via Form 484 (online only) within 28 days of the director's death.

Reversionary versus non-reversionary death benefit pensions

- A *reversionary pension* is one that does not cease on death
- Documentation (Pension Agreement, Minutes/Resolutions, etc) confirm the income stream is to automatically 'revert' to a beneficiary on death
- It continues to the nominated recipient seamlessly
- Without such documentation, the pension is *non-reversionary*
- A non-reversionary pension ceases on the death of the primary recipient
- The capital goes back *to accumulation mode – and subject to tax on earnings (maybe?)*
- *The surviving spouse can commence a death benefits pension*
- *This would be a new income stream.*

Capital Gains Tax on paying death benefits

TRUE or FALSE – Capital Gains Tax would be payable in this scenario?

- Barry is a widower and sole member of his SMSF
- He has an account based pension with a capital value of $1.2m
- This income stream has been running for 15 years
- The assets of the fund include a property valued at $450,000 with a cost base of $200,000
- Barry has one child, Dwayne, who is an independent adult.

Capital Gains Tax on paying death benefits

- Barry passes away on the 1st of July 2021 and leaves his superannuation entitlement to his son
- Dwayne sells the property on 1 September 2021 for $450,000 to fund the lump sum death benefit (which is paid on 1 December 2021)
- Even though the property was used to fund a pension just prior to Barry's death, because there was no member who is automatically entitled to be paid a death benefit pension, the income stream ceased on Barry's death and his benefit reverted back to accumulation mode
- Therefore:

Sale Price	$450,000
Less: Cost Base	($200,000)
Net Capital Gain	$250,000
Less: CGT discount	($82,500)
Assessable Capital Gain	$167,500
CGT payable by SMSF	($25,125)
Net Amount	**$424,875**

- *Will there be $25,125 CGT payable on the sale of the property to pay the lump sum to Dwayne?*

Capital Gains Tax on paying death benefits

- NO!
- The amendments introduced in the *Income Tax Assessment Amendment (Superannuation Measures No.1) Regulation 2013* clarified how the Exempt Current Pension Income and tax free and taxable components are calculated regarding a death benefit arising from a non-reversionary pension:
  - Exempt Current Pension Income continues after death, if benefit is dealt with *'as soon as practicable'*.
  - Either as a lump sum, new superannuation income stream, or a combination of the two.
- Therefore in the previous example, if Dwayne pays Barry's benefit as a lump sum *'as soon as practicable'*, the Exempt Current Pension Income status of Barry's pension assets continues and SMSF will not incur the $25,125 CGT
- This increases the lump sum benefit payable to Dwayne
- *Bear in mind the regulatory amendments do not remove an obligation to pay lump sum tax where the benefit is received by non-tax dependants.*

Separate Superannuation Interests

- But it gets better!
- Earnings from the date of the primary pensioner's passing to the time the benefit is dealt with will also be considered amounts used to fund a superannuation income stream and therefore exempt from tax
- The regulation also creates an alternative method for calculating the tax free and taxable components of certain superannuation benefits paid after the death of a person who was receiving a superannuation income stream immediately before their death:
  - Tax free and taxable components retain their proportions
  - This includes earnings on the assets supporting the pension, but does not include additions arising from insurance proceeds.
- *What does this mean in plain English?*

Example - Separate Superannuation Interests

- Betty was in receipt of a non-reversionary pension at the time of her death on 1 July 2021
- Betty's spouse, Simon, wants to take Betty's benefit as a death benefit pension
- Betty's benefit in the fund was $650,000 at the time of her death, consisting of 50% tax free and 50% taxable components
- Simon commenced a pension on 1 November 2021 which was the earliest Betty's benefit could be dealt with
- Betty's benefit had increased in value by $50,000 from 1 July 2021 (the date of death) to 1 November 2021 (the date Simon commences a death benefit pension)
- Therefore the death benefit pension amount is $700,000
- *How are the $50,000 earnings treated?*
- *HINT – normally, earnings on an accumulation account are a taxable component.*

Example - Separate Superannuation Interests

- *The $50,000 will be considered earnings on a pension account*
- This is because immediately prior to death, the capital was used to support a pension
- So long as it is dealt with *'as soon as practicable' it will still be considered earnings on a pension account*
- The $700,000 benefit will be 50% tax free and 50% taxable
- However, if not dealt with *'as soon as practicable'*, the $50,000 earnings would be a taxable component:
  - Tax free $325,000 (46.42%)
  - Taxable $375,000 (53.58%)
- If dealt with *'as soon as practicable'*, the components of the pension would be as follows:
  - Tax free $350,000 (50%)
  - Taxable $350,000 (50%)

What does ‘as soon as practicable’ mean?

- The ATO’s general rules of thumb is six months from the date of death (Death Benefits Period)
- However, it can take longer in some circumstances
- What does the ATO consider an acceptable delay (i.e. longer than 6 months):
  - Taking time to seek specialist advice
  - Delays in determining the validity of a Binding Death Benefit Nomination
  - Trying to locate beneficiaries.
- Where >6 months is seen as an unacceptable delay:
  - Waiting for the ‘right time’ to sell an asset
  - The fund having insufficient cash to pay the benefit
  - The Trustees having personal issues and not being able to administer the fund.
- *Why is this an issue?*

Case Study – Separate Superannuation Interests

- Bill, 67, was in receipt of two non-reversionary pensions – one 100% tax-free and one 100% taxable
  - Tax Free Pension $500,000 (50%)
  - Taxable Pension $500,000 (50%)
- Fund assets are worth $1m, with a cost base of $500,000 ($500,000 unrealised gain)
- Bill passed away on 1 July 2021 and does not have a death benefit nomination in place
- Bill's wife, Wendy, Bill's Executor, decides to pay the 100% tax-free pension as a cash lump sum to their adult child Mark on 1 September 2021
- Wendy decides to take Bill's 100% taxable pension as a death benefit pension on 1 September 2021.

Case Study - Separate Superannuation Interests

- Assets are sold within the Fund to allow for the cash lump sum to Mark
- *The Fund earns 10% from the date of Bill's death until the benefits are paid*
  - *The fund is now worth $1.1m*
- If the death benefit is paid as soon as practicable:
  - The assets sold to fund the tax free lump sum to Mark will be included in Exempt Current Pension Income (no CGT)
  - Earnings on the assets used to pay pensions will be in the same proportion of tax free/taxable components
  - Also the superannuation interests remain separate superannuation interests and can be dealt with separately.

Case study - Separate Superannuation Interests

- If ***not paid out*** as soon as practicable:

CGT on sale of assets:

Sale Price	$550,000
Less: Cost Base	($250,000)
Net Capital Gain	$300,000
Less: CGT discount	($100,000)*
Assessable Capital Gain	**$200,000**
CGT Payable by SMSF	($30,000)
Net Amount	**$520,000**

- * Inside super the CGT discount rate is one-third if asset held for >12 months.

Case Study - Separate Superannuation Interests

- If ***paid out*** as soon as practicable:
  - Earnings on the assets will be in the same proportion as the superannuation interests (i.e. either tax-free or taxable).
    - Tax Free Pension $550,000 (50%)
    - Taxable Pension $550,000 (50%)
- If ***not paid out*** as soon as practicable:
  - The two superannuation interests would be mixed on death
  - The Fund would consist of *one accumulation account worth $1.1m*
  - *Earnings on an accumulation interest are a taxable component*.

Case Study - Separate Superannuation Interests

- If ***not paid as soon as practicable***, earnings would be on an accumulation benefit and therefore a taxable component:
  - Tax Free Component $500,000 (45.45%)
  - Taxable Component $600,000 (54.55%)
- Therefore Mark would receive a benefit that was part tax free/taxable:
  - Tax Free Component $243,158 (45.45%)
  - Taxable Component $291,842 (54.55%)
- *Mark's benefit is only $535,000 because $15,000 CGT is deducted first*
- ***Therefore lump sum tax on the taxable component of $291,842 x 17% = $49,613 lump sum tax payable.***

Case Study - Separate Superannuation Interests

- If the death benefit is ***<u>not paid out as soon as practicable</u>***:
- Net amount received by Mark = $550,000 - $15,000 (CGT) - $49,613 (lump sum tax) = $485,387
- Three key issues with the death benefit:
  - The superannuation interests ceased to be separate superannuation interests on death
  - Assets sold to fund the lump sum to Mark will be in accumulation mode and subject to CGT
  - Earnings on the assets will be a taxable component.

Separate Superannuation Interests

- *If paid within the death benefits period and as soon as practicable*:
- Net amount received by Mark = $550,000 (a difference of $64,613)
- No CGT of $15,000 and no lump sum tax of $49,613
- This is because:
  - The superannuation interests remain separate superannuation interests on death and can be dealt with separately
  - Assets sold to fund the lump sum to Mark will be included in Exempt Current Pension Income (no CGT)
  - Earnings on the assets will be the same proportion as the superannuation interests (i.e. either tax free or taxable).

Lumpy assets in an SMSF

- Death benefits must be paid as soon as practicable
- If a spouse (or other tax dependant) is the recipient of the death benefit, property can remain in the fund
- The fund would need to make sure it has the liquidity to meet pension payments
- However if the recipient of the death benefit is an adult child, a lump sum death benefit must be paid
- Delays due to:
  - Waiting for the 'right time' to sell an asset
  - The fund having insufficient cash to pay the benefit
  - The Trustees having personal issues and not being able to administer the fund.
- Are not valid reasons and the issues raised previously will apply
- *How can lumpy assets be dealt with when part of a death benefit?*

Lumpy assets in an SMSF

- There are several options available:
  - Pay the property out as an in-specie death benefit lump sum
  - Related party would then be able to live in it if residential property
    - There may be Stamp Duty implications, although most jurisdictions have an exemption if being paid to a member
    - If transferred as soon as practicable, should be no CGT if was used to fund a pension
    - If death benefit from accumulation mode, then CGT needs to be considered
    - Lump sum tax may also be applicable and needs to be considered.
  - If the benefit to be paid is less than the value of the property:
    - Can do a partial in-specie transfer:
      - The SMSF and the member could then own the property as tenants-in-common
      - This is allowable, even with residential property
      - Related party would not be able to live in the property if residential.

Example – Lumpy assets in an SMSF

- Janis (66) and Jim (68) have an SMSF worth $2m
- The fund is 100% in pension mode
- The pensions are non-reversionary
- Each member account is $1m
- The principle asset in the fund is a commercial property, recently valued at $1.5m
- The cost base is $500k
- The idea was to sell the property later this year to capitalise on the buoyant market and not incur CGT
- They each have a BDBN to each other, and then their Legal Personal Representative (i.e. the Executor of their estate)
- Jim dies suddenly on 1 December 2021 from heart failure
- Janis wants to retain the property, as it has a 10% rental return every year
- *Can she do this?*

Example – Lumpy assets in an SMSF

- Yes.
- Janis may have to commute some of her own pension back to accumulation
- But she can retain the property in the fund if she wants to take Jim's benefit as a pension
- *What if she wants to take Jim's benefit as a lump sum?*
- The fund does not have sufficient other assets to retain the property in the SMSF
- Only $500k other assets in the fund
- So some of the property can be transferred in-specie to Janis ($500k)
- She can hold the property with the SMSF as tenants-in-common
- Will the fund incur CGT? Remember cost base of $500k
- No – the asset was being used to support a pension just prior to the death benefit lump sum
- But must be paid as soon as practicable (Off Market Transfer and change of ownership on property title)
- *But there may be Stamp Duty and other considerations.*

How many death benefits can be paid?

- Death benefits may be cashed in the form of an interim lump sum and a final lump sum
- Therefore, the deceased's benefit must be 'cashed', in the form of two lump sums and/or a pension or pensions, and if lump sums are chosen as the death benefit payment option, trustees must structure the fund's affairs around two such payments
- This contrasts with ordinary lump sums where if the member has satisfied a condition of release such as retirement and their superannuation consists of unrestricted non-preserved benefits, they are entitled to as many lump sums as they wish
- A similar logic applies with pension payments
- A member may take multiple pension payments a year as they wish.

What happens if there is a breach of the rules?

- A breach of the death benefit payment rules may mean the fund receives a qualified audit report, which can be quite distressing at an already upsetting time
- The ATO does mention on its website the importance of trustees understanding and complying with the death benefit payment rules
- They also mention the importance of trustees engaging with the fund auditor if they believe there has been a breach
- While we have not seen any penalties levied on trustees breaching the death benefit payment rules, there are provisions for breaches of the SIS legislation and regulations
- It is important SMSF trustees and members understand the rules so they can plan for the death of members and ensure compliance with the super rules, as well as minimising the stress and heartache when a loved one passes away.

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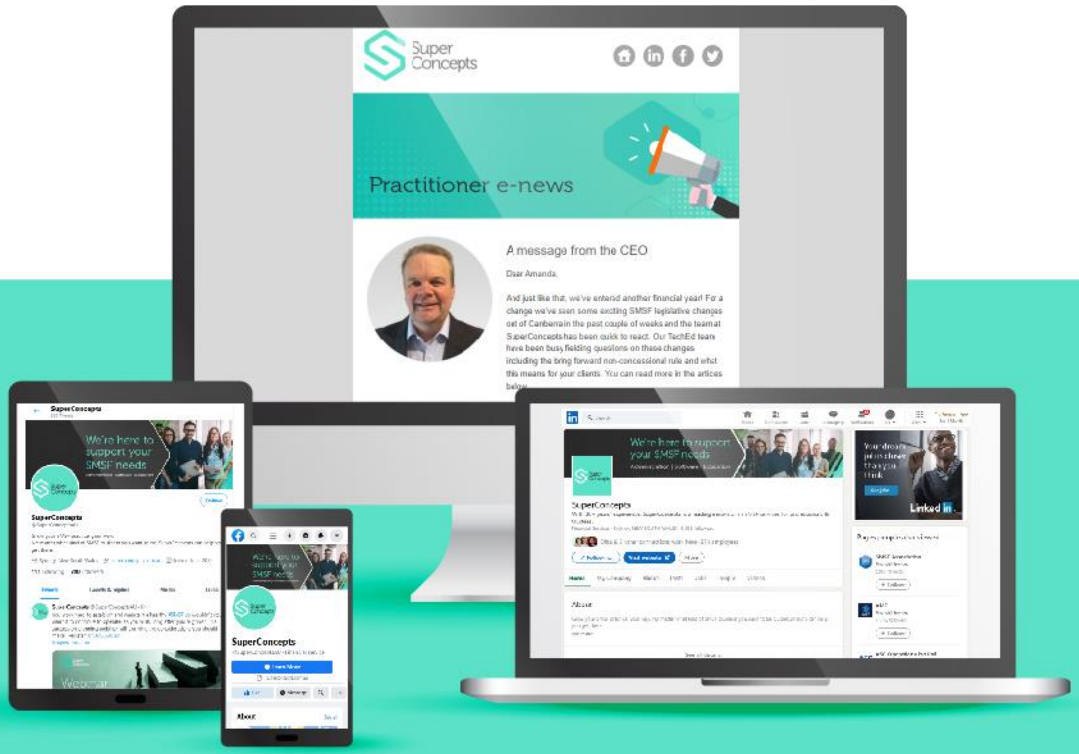

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December 2021