Succession Planning in SMSF: Getting out or passing down

morrows

the difference is significant

Murray Wyatt FCPA

CPA Australia SMSF Conference

April 2013

Ph: 03 9690 5700
Fax: 03 9690 6509
Email: mwyatt@morrows.com.au
Website: www.morrows.com.au

What we will cover

- **Trustee-member rules**
- **Trustee succession**
  - Individual v Corporate Trustees
  - *Katz v Grossman* example
- **Reversionary pensions**
- **Binding death benefit nominations**
- **Hardwiring deeds**
- **Invalidity (or incapacity)**
- **Insurance - TPD premiums deductibility**
- **Anti detriment payments**

Trustee-member rules for SMSFs

morrows

- **Definition of SMSF outlined in s17A of the SISA**
  - Have less than 5 members
  - Each trustee/trustee director is a fund member, unless a single member fund
  - Each member of the fund is a trustee/director
  - No member of the fund is an employee of another member unless related
  - No trustee receives remuneration for trustee services
  - The fund is a resident regulated superannuation fund

Trustee-member rules for SMSFs

morrows

- Children (under 18) can be members,
- and their parents can hold office as a trustee (or director of a corporate trustee) in their place
- Enduring powers of attorney can be used in case of incapacity once the fund is established
- But not to establish a SMSF

Trustee-member rules
Who are members of your SMSF?

morrows

- Once over 18, children have the legal right to be trustees (or directors of corporate trustee)
- This gives rise to a succession planning opportunity via the trustee of the SMSF
- Assets can be allocated to member accounts via the SMSF – segregation of assets
- **But....**

REMEMBER FAMILY DYNAMICS

morrows

Trustee-member rules
Who are members of your SMSF?

morrows

- If employer company is also trustee of SMSF
- Consider whether it is a wise decision to have children as directors of that company?
- Consider *Triway Superannuation Fund and Commissioner of Taxation* [2011] AATA 302,
- where a drug addicted son ‘cleaned out’ the SMSF where the son and his parents were members
- Family feuds can also make SMSFs difficult to run!

Trustee-member rules
Who are members of your SMSF?

morrows

- In *Basil Notaras v Brinos Notaras* [2012] NSWSC 947, two brothers refused to co-operate in relation to their joint SMSF, due to a separate family feud
  - Brinos withdrew almost $60,000 more than his member entitlement from the fund, and also refused to sign a number of compliance documents (eg, tax returns)
  - Order granted from the NSW Supreme Court to have Brinos replaced as trustee
  - A very expensive and painful process!

Trustee succession

Consider Trustee Succession

– Whoever holds office as trustee will impact on how death benefits are paid

– As such, this is an important aspect of SMSF succession planning

– Need to examine the differences between:

Corporate v Individual Trustees

Trustee succession
Individual trustee

- The deed will usually outline who succeeds an individual trustee – generically expressed
- If individual trustees, usually (under the trust deed) the survivor trustee will have power to change the trustee
- This is common in a lot of deeds, ok for perhaps Mum and Dad (depends on facts), but for siblings or business partners?
- Alternatively, the legal personal representative (‘LPR’) of the deceased member will be appointed – a safer approach
- When an individual trustee dies, change of trustee documents may need to be executed to appoint the replacement

Trustee succession
Corporate trustee

morrows

- Smoother succession occurs with a corporate trustee (simply change director)
- The company will continue on after the member's death
- This means no change of trustee upon member's death
- Change of director forms must be lodged via ASIC
- ATO will also need to be notified

Trustee succession
Corporate trustee

Advantages of a Corporate Trustee

- Asset protection – the capacity argument
- More efficient for estate planning as follows:

  Successor directors can be nominated via the constitution to allow them to hold office after the death of the member

  - Eg, constitution may allow a director to appoint a successor director in their place after their death
  - To implement this an additional agreement/nomination of successor director may be needed

Trustee succession
Corporate trustee

Advantages of a corporate trustee (continued)

- Shares in the company can be gifted via the deceased member's will
- Less administration when a member dies – no change of trustee required
- If no corporate trustee, it can be cumbersome from a registration viewpoint if there are numerous assets such as property or shares

Individual trustees can be dangerous ?

morrows

Example below is adapted from *Katz v Grossman* [2005] NSWSC 934, a leading case on SMSF succession:

- Mr and Mrs Katz were individual trustees and members of an SMSF
- Mrs Katz died and Mr Katz was the sole surviving trustee and member
- He appointed his daughter, Linda Grossman as a trustee in place of his wife
- Mr Katz also signed a ‘non-binding’ death benefit nomination
- Non-binding nomination not discussed in detail in judgment
- Likely that nomination did not comply with relevant provisions of SISA (s 59)
- Nomination was probably similar to the standard pro forma ‘non-binding’ nomination handed out by public offer funds – needs to say it is binding and be properly witnessed!

Katz v Grossman Example
Individual trustees can be dangerous?

morrows

- Mr Katz intended for both his daughter (Linda) and son (Daniel) to benefit from his superannuation assets
- When Mr Katz passed away, Linda was left holding office as the sole trustee of the fund
- Linda appointed her husband, Peter, as a second individual trustee of the fund
- Linda and her husband then resolved to pay Mr Katz's death benefits entirely to her
- NSW Supreme Court held that Linda's appointment of her husband was valid

Katz v Grossman Example Superannuation Succession

morrows

How could this injustice against Daniel been avoided?

- Have a corporate trustee!
- The trustee could have continued with Mr Katz as the sole director after Mrs Katz's death
- Successor directors could be nominated to specifically succeed Mrs Katz, depending on constitution eg, Mr Katz nominates Son and Daughter
- Or complete a valid binding death benefit nomination ('BDBN')
- If Mr Katz properly executed a BDBN, the trustee (Linda and her husband) would be bound to follow it

Trustee succession

- Despite advantages of corporate trustee, the majority of SMSFs have individual trustees
- As at 30 June 2011, 74% of SMSFs had individual trustees
- 90% of SMSFs established in the year ended 30 June 2011 were established with individual trustees

  (source: self-managed superannuation funds. A statistical overview 2009-10. ATO publication)

Why?

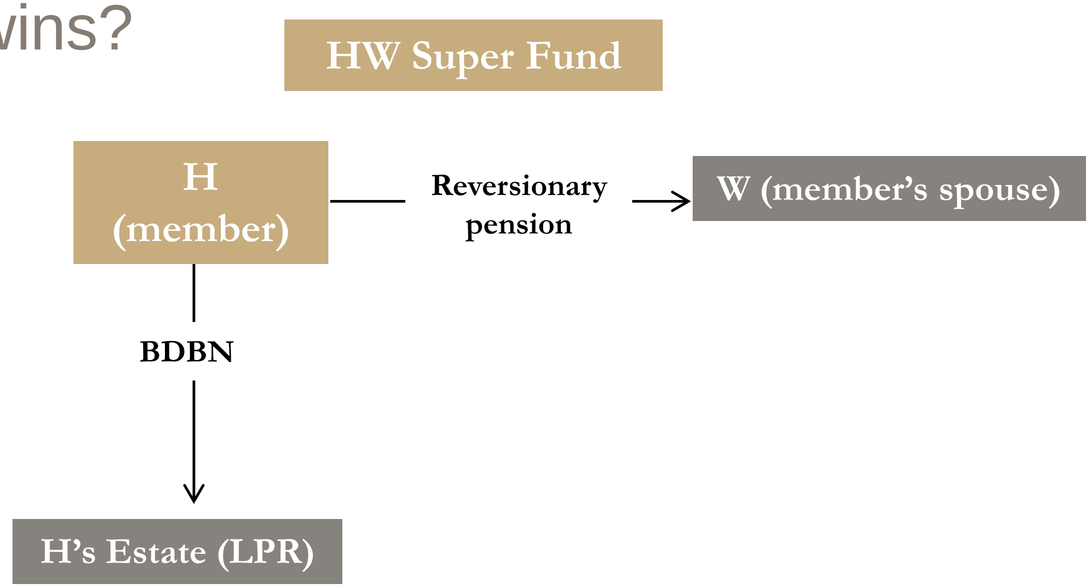
Pensions on death
Auto-reversionary v BDBN

morrows

- Auto-reversionary pension vs binding death benefit nomination (‘BDBN’)
- Which one wins?
- Example:
- H and W are members of the HW Super Fund
- H has a reversionary pension in place that will revert to W on his death
- Additionally, H has a BDBN that directs the trustee to pay all his super to his estate
- If H dies, which of the pension v BDBN will win?

Pensions on death
Auto-reversionary v BDBN

- So what we have is an Auto-reversionary pension vs Binding Death Benefit Nomination ('BDBN').
- Which one wins?



Pensions on death
Auto-reversionary v BDBN

morrows

Example: (continued)

- It depends on the deed?
- Established principal of law is that a trustee cannot fetter their discretion
- 'Fetter': is not a type of cheese; it refers to a restriction
- One exception to this principal is where the deed provides a restriction (*Muir v Inland Revenue Commissioners* [1966] 1 WLR 1269, 1283)
- SMSF deeds should provide a valid fetter of a trustee's discretion in relation to the BDBN, which will bind the trustee to follow the BDBN

Pensions on death
Auto-reversionary v BDBN

morrows

- Notwithstanding, honouring pension documentation, eg reversionary pensions, will still be at the discretion of the trustee
- The pension documents are a mere request of the trustee, the trustee has the option whether to honour this request
- <u>However</u>, BDBNs usually bind the trustee
- For example, consider the clause in Morrows' trust deed

11. The Trustee exercises its powers subject to any written direction signed by a Member in respect of:

(a) a nominated Beneficiary who is to receive benefits on the death of a Member…

- the trustee's discretion under the deed is restricted by this clause, (a valid fetter) which relates to BDBNs

Pensions on death
Auto-reversionary v BDBN

- Documentation is the key
- Have a trust deed, BDBN and pension documents that aligns
- Ensure that the deed is updated to provide for BDBNs
- Note that ‘reversionary’ pension documentation may not be essential from a tax perspective once draft legislation is finalised (finalising TR 2011/D3)

Reversionary pensions – legal update

morrows

Finalisation of TR 2011/D3

- Draft ruling concerned with when a pension ceases (including cessation on death of a member)
- Draft ruling highlighted the importance of reversionary pensions and binding death benefit nominations
- Further draft legislation has been released that will allow the tax free status of a pension exemption to continue after a member's death, regardless of whether it is a reversionary pension
- Currently if you don't have a reversionary pension via pension documents or BDBN, the pension ceases on death of the member – resulting in a loss of tax benefits

Reversionary pensions – legal update

morrows

Finalisation of TR 2011/D3 (continued)

- The proposed legislation will impact the tax treatment when assets supporting a pension are sold
- These assets can potentially be sold tax-free, even if the pension is not reversionary and does not continue after death
- Proposed legislation will apply retrospectively from 1 July 2012
- (see Exposure Draft legislation for 'Tax Certainty for Deceased Estates', released on 29 January 2013)

Pensions on death hardwiring trust deed

morrows

- ‘Hardwiring’ a trust deed with member’s succession is also an option
- Particularly useful for ‘blended families’
- Example:
  - John Smith (‘JS’) is currently married to a second spouse (‘W’)
  - He has children from his first marriage, and a stepson from his second
  - John has the JS Super Fund and he ‘hardwires’ the trust deed to provide an income stream for his second spouse during her lifetime (without access to capital)
  - The capital is to go to his children from his first marriage

Pensions on death hardwiring trust deed

Blended Family Example – using hard wired trust deed

JS Super Fund

(with hard wired trust deed)

JS (member) → Reversionary pension → W (member's 2nd spouse)

Restrictive Terms, including:
- *Maximum Amount payable to W*
- *No option to roll back pension during W's lifetime*
- *'Guardian' type role to make changes to terms in trust deed*

Gifted to JS's children via W's estate* → JS's children from first marraige

**Note, this assumes that JS and W have aligned their estate planning to achieve this. This requires more than just a 'hardwired deed'*

- 'Guardian' will need to be a party to a variation to the deed
- Guardian could be JS's children from first marriage
- For this example to be effective, W and JS must agree to align their estate planning
- This requires a mutual wills agreement, as well as W including JS's children in her will
- Depending on family dynamic, it may not work in all circumstances.
- It requires, JS, W and JS's children to all work together!

Pensions on death hardwiring trust deed

morrows

Additional Example: Blended Family using hard wired trust deed

JS 1 Super Fund

JS 2 Super Fund

(with hard wired trust deeds)

JS (member)

JS (member)

W (member's 2nd spouse)

JS's children from first marraige

Smaller balance exposed to risk of redirection or kiss it goodbye

(from prior example)

- W has the right notwithstanding a mutual will to change it, to say give her child the benefits
- Changing it may assist a TFM claim in the courts, by JS's children, but she has the right!

Solution

- JS can establish two super funds and quarantine his super benefits payable to each of his second spouse and bloodline children
- Hard wired trust deeds could be used to 'lock in' his succession to the respective beneficiaries in the actual trust deed
- This would mean that his super benefits could not be changed via his estate
- Further, the administration of his super funds after his death would be clear, due to the directions in the deed

Reversionary pensions, BDBNs, hard wiring – a comparison

morrows

Succession planning tool	Advantages	Traps
Reversionary pensions	•Requests trustee to follow member's request •Allows pension to continue after death, particularly useful for ATO's tests (eg, TR 2011/D3)	•Should align with BDBN, BDBN will usually override pension docs •TR 2011/D3 is going to be finalised shortly (solves tax complexity)
BDBNs	•Binds trustee to follow member direction •Usually trumps reversionary pensions •Can be flexible in their application	•Deed must provide for BDBN •Must be executed correctly (per SISA s 59(1A)) •More complex BDBNs may require tailoring by legal professionals
Hard wired deed	•Most effective way to 'lock in' superannuation benefits •Gives member ability to rule beyond the grave? •Suitable for blended families	•Can be very restrictive once drafted •Costly to implement and maintain •Not suitable for everyone (usually pensions and BDBNs are sufficient)

Invalidity/Incapacity

- Focus of presentation so far has been on succession on death
- But what if a member became incapacitated during their lifetime?
- Importance of enduring power of attorney (‘EPoA’)
- Person holding an EPoA in respect of a member can make decisions on behalf of the member in relation to their SMSF
- Legislative power for this to happen per SISA s 17A(3)(b)
- ATO gives further guidance per SMSFR 2010/2
- Having EPoA is not enough, the attorney must be appointed to office of trustee

Invalidity/Incapacity

morrows

- <u>Example:</u>
- Andrew and Bernice are individual trustees and members of the AB Super Fund.
- Andrew works in the CBD and unfortunately gets hit by a bus on his way to work, which sends him into a coma
- What if Andrew did not grant an EPoA?
  - Bernice cannot make trustee decisions by in relation to the fund by herself.
  - Both trustees are required to make decisions
  - Hope that deed provides for trustee succession if there is incapacity?
  - Apply to VCAT (or similar tribunal) for an order
  - But this can be costly, and Bernice is not guaranteed to be picked as attorney

Invalidity/Incapacity

morrows

- Example continued:
- A lot easier if Andrew had signed an EPoA
- A corporate trustee will also greatly assist with this succession planning
  – Successor directors can be nominated via the constitution to allow them to hold office after the death of the member
  – Eg, constitution may allow a director to appoint a successor director in their place after their death
  – Additional agreement/nomination of successor director may also be needed
  – Shares in the company can be gifted via the deceased member's will
  – Despite the directors of the corporate trustee making decisions of the company, the shareholders will be able to control who is appointed as a director

Insurance Premiums

morrows

TPD premiums deductibility for 2012 year

- ***Any Occupation* –** those deemed unlikely to ever again be gainfully employed in any occupation
- ***Own Occupation* -** unlikely to ever again be gainfully employed in their current occupation
- ***Own Occupation TPD & Life Insurance* Bundled* –** Own occupation policy bundled with a life insurance policy

Insurance Policy	Deduction Available (%)
"Any-Occupation" TPD	100%
"Own-Occupation" TPD	67%
"Own-Occupation"/Life Insurance Bundled	80%

*Life Insurance policies remain fully deductible in the fund"

Anti-detriment

morrows

- Anti-detriment amount refunds 15% contributions tax on benefit accrued between 1988 and the date of death
- Must be paid as a lump sum to the beneficiaries
- Current or former spouse; children including adult children or the estate
- Cannot reduce the deceased or another member’s balance to pay anti-detriment
- Cannot borrow to make anti-detriment
- Anti-detriment deduction must be made in the year of the payment
- If no FITB or reserve will be restricted to the amount of tax refund

Calculating anti-detriment payment

- Audit method – actual contributions tax paid, including earnings on those amounts (see ATO ID 2008/111)
- Alternative method in EM
- Involves auditor certification of exact amount (rarely used in practice)
- EM formula method (rarely used in practice)
- ATO's formula in ATO ID 2007/219 (see also ATO ID 2010/5)
- Most common and easiest way to calculate anti-detriment payment

Standard formula
Calculation of top up amount

morrows

ATO ID Method (ATO ID 2007/219 and ATO ID 2010/5)

C x 0.15 x P / (R – 0.15 x P)

- **C =** taxable component (excluding insurance for which deductions claimed)
- **P =** days in service period R after 30 June 1988
- **R =** days in service period after 30 June 1983

Three ways to fund the payment

morrows

- Reserves
- Insurance
- FITB (other members’ balances)

Anti-detriment example

- James is a member of the Smith Superannuation Fund ('Smith SF'), a newly established SMSF
- During the year ending 30 June 2013, James' employer makes $25,000 of contributions to the fund (concessional contributions)
- Tax is payable within the fund at a rate of 15%
- Therefore tax payable on the contribution is $3,750
- As such, James' balance in the fund is $25,000 - $3,750 = $21,250
- James dies before 30 June 2013
- His BDBN states that a lump sum is to be paid to his spouse

Anti-detriment example (continued)

morrows

- The trustee of the Smith SF decides to implement an anti-detriment strategy
- The 'top up' payment is $3,750, which represents the actual tax paid on James' member balance
- James' spouse will receive his member balance ($21,250) plus the top up payment ($3,750), which totals $25,000
- In addition, the Smith SF can claim a deduction on the anti-detriment payment
- Anti-detriment deduction is calculated as:

  $3,750/0.15 = $25,000

- Where 0.15 represents the 15% tax payable within the fund

Anti-detriment example

morrows

- Advantages for Smith SF using anti-detriment strategy
  - James' spouse receives an increased benefit, due to the 'top up' amount being included in James' death benefit $25,000
  - The Smith SF can claim an additional tax deduction (ie, the grossed up 'top up' amount $25,000)
  - Remember it's a deduction/rebate not a refund

Questions?

- Murray Wyatt
- Morrows
- mwyatt@morrows.com.au
- (03) 9690 5700

morrows

the difference is significant

Glossary

- **BDBN – binding death benefit nomination**
- **EM – explanatory memorandum**
- **EPoA – enduring power of attorney**
- **LPR – legal personal representative (executor)**
- **SISA – *Superannuation Industry (Supervision) Act 1993* (Cth)**
- **SISR – *Superannuation Industry (Supervision) Regulations 1994* (Cth)**