SUPERCENTRAL

Asset rich cash poor – meeting cash obligations with all eggs in one basket

What to do when the fund owns a property and one of the members dies. Can the fund delay selling the property to pay the death benefit?

A self-managed superannuation fund ("SMSF") is an investment vehicle granted tax concession because it has the sole purpose of providing aged pensions in retirement for its members. Members have the ability to effectively pool their resources and build wealth over time through their SMSF. They can invest in almost anything as long as the investment is consistent with the investment strategy of the SMSF.

Many people decide to have an SMSF in order to invest in property. As a long term investment, property can appreciate over a number of years providing important capital gain for the fund and in the meantime can earn income through rent payments received from the tenant.

The problem with acquiring a property in an SMSF though is that it is indivisible, can take up a huge chunk of the investment portfolio of the SMSF and has issues with liquidity. It is what is called 'lumpy' by the industry.

The fund's resources may be nearly exhausted in acquiring the property leaving little for the SMSF to use to diversify into other more liquid assets in order to meet its cash obligations should an emergency payout arise.

Planning ahead

When a member passes away, the death benefits of the deceased member have to be cashed out as soon as practicable. If an SMSF has a property with very little cash, what can the trustee do to make sure that the corresponding death benefits are paid if one of the members suddenly passes away but the surviving members want to keep the property in the fund?

Establish Pension under Binding Death Benefit Nomination ("BDBN")

In the case of SMSFs with husband and wife members, they can execute BDBNs nominating each other as their respective death benefit dependants. If one of them passes away, the death benefit dependant can opt to receive the death benefits as a pension with annual payment set to statutory minimum which may alleviate the need to sell the property straight away.

This option does not apply to a beneficiary who is not a death benefit dependant (e.g. father and child member where child nominates father as beneficiary and the child passes away). As a non-death benefit dependant, the death benefits of the deceased member can only be cashed out as a lump sum thereby forcing the SMSF trustee to come up with either cash or property to distribute to the non-death benefit dependant.

Insurance outside the SMSF

Both members can take out term life insurance over the life of the other outside of the SMSF. If one of them dies, the surviving member can contribute the insurance proceeds to the SMSF which can then be used by the SMSF trustee to pay the death benefits in cash (either as pension or lump sum).

The drawback of this option is that it does not work well with death benefits of large amounts as the amount of insurance proceeds to be contributed to the SMSF cannot exceed the beneficiary's contribution caps. As the life insurance is taken outside of the SMSF, the members pay for the premiums out of their own pockets.

The same kind of strategy cannot be implemented within the SMSF (where the premiums are deducted from the member's account in the SMSF) as cross-insurance arrangements where the insurance proceeds are paid to someone other than the insured member are prohibited under the regulations. Insurance proceeds from a policy taken out by the trustee and paid for from the deceased member's account in the fund only add to the deceased member's death benefit and can't be used as a substitute for payment of their share of the fund's property's value.

Contribute cash to the SMSF

A surviving member who has cash outside of the SMSF can make contributions to the SMSF to enable the SMSF trustee to pay the death benefits to the death benefit dependant. However, a surviving member can only contribute cash up to the contribution caps provided by existing laws. It only works if the amount of death benefits to be cashed out is within the contribution caps.

In specie transfer of part of property

While there is a requirement to make a cash out of the death benefits as a lump sum (if pension is not possible), there is no requirement that the lump sum be paid solely in the form of cash. The SMSF can also make an in specie transfer of part of the property to a death benefit dependant as a non-cash lump sum. The disadvantage of this option is the serious tax consequences of the transfer especially if the SMSF is in the accumulation phase.

Sell the property at market value

If no other strategy is possible the fund will be forced to sell the property at market value and use the proceeds of the sale to pay the death benefits. Issues to be considered include the length of time it takes for the property to get sold, the amount of money it earns from the sale and the expenses and taxes to be paid after the sale.

If the surviving members want to retain the property as part of their overall investment portfolio they can buy the property from the fund as long as the necessary compliance requirements are met. They could in theory even contribute it back to the fund though issues like contribution caps could make this an unlikely strategy.

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A final word

The prudent approach in the case of an SMSF with a lumpy asset is to plan well ahead so that the value of the property and potential tax savings in an SMSF environment are maximised to the fullest while at the same time making sure that the SMSF is able to meet its cash obligations when an emergency arises. The property was placed in the SMSF as a long-term investment so the goal is to keep it for as long it can until it is the right time to sell.

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