SMSF Snakes and Ladders

In 2015 I called the height of the SMSF industry in terms of strategic uses. With a Labor Government, favouring Industry Super in for at least two to three terms, expect an all out assault on SMSFs. It might not be what you want to hear but let's face it if the Coalition government can introduce an administratively cumbersome Transfer Balance Cap and the dreaded Non-Arm's Length Expense laws, then ????

Anyway, in my last article I laid out the competencies to provide advice on SMSFs. These were once codified into the Financial Services training package but are no more. But in my mind they are still the bare minimum of what is required in terms of being able to advise on SMSFs.

I thought in this article that I would again test your knowledge and lay out a major trap that many advisers have right under their very noses that can cost them significantly in a strict liability suit under section 54C and 55(3) of SISA. Plus a little tax deferral treat given to us by Pauline Hanson that can be used to defer and if played right permanently reduce tax using superannuation. Read and test these a few times and would love to know your thoughts – contact me on grant@abbottmourly.com.au

1. **Single Member SMSF Succession Disaster**

The following table taken from the December 2021 ATO statistics show the disaster on our horizon, one I have seen many accountants and planners fall into, even the best and brightest SMSF advisers. What do you think it is?

Table 4: Proportion of funds by number of members (%)

Number of members	2019–20	2018–19	2017–18	2016–17	2015–16
1	23.7%	23.4%	23.2%	23.1%	22.9%
2	69.2%	69.3%	69.4%	69.4%	69.5%
3	3.4%	3.6%	3.6%	3.7%	3.7%
4	3.6%	3.8%	3.8%	3.8%	3.9%
Total	100%	100%	100%	100%	100%

***Source**: ATO statistics December 2021*

I am always surprised, coming as the Chair of the Succession, Asset Protection and Estate Planning Advisers Association that succession planning in SMSFs is as rare as a Tasmanian Tiger. After all, with six member SMSFs how can it be that 23.7% of SMSFs have one member?

If you don't see a problem with no succession planning, then read on. Let's consider what can happen on the death of the single member in a SMSF?

a) Section 17A(2) of SISA provides that a single member SMSF is required to have either a corporate trustee where the single member is the director or another person becomes a trustee in addition to the single member trustee of the fund[1].

[1] Why anyone would be a co- trustee of a Fund and not be a member is beyond credulity. With the potential fines for individual trustees, no ability to be indemnified and caught out at death, any SMSF adviser letting this happen is exposed for loss or damages incurred by the no-member trustee.

b) Assuming the majority of single member SMSFs have a corporate trustee what happens when the single director dies?
    i. If the adviser has not set in place a Successor Director solution, enabling the Executor of the deceased member's estate to become a Director in place of the deceased member director – as per section 17A(3)(a) of SISA, the corporate trustee has no ability to act and is rudderless.
    ii. The result may be that this leaves the Fund with no trustee and as a result the fund may breach section 19 of SISA thereby precluding the fund being a regulated superannuation fund.
    iii. If the fund is not a regulated superannuation fund, then section 42A of SISA would render it a non-complying superannuation fund[2].

So, the Successor Director solution is a must, and you can tell whether you have the ability to insert a Successor Director by reading the constitution. Now if you have not read your client's SMSF trustee constitution to see what happens on death and whether there are any limitations then, you need some upskilling as this is one of the prime competency standards for providing advice on SMSFs.

But my lawyer says it does not matter as the shares held by the former member/director of the SMSF will pass to the estate and the Executor can make themselves a director?

I hear this all the time and sounds good in theory, but does it work in practice?

First off, the shares will be vested in the Executor of the estate if there is a Will. One of the first issues for the Executor to receive legal advice on is when can they, under the various State Succession Acts, deal with those shares? Many states prohibit a dealing within a period of time pending a potential family provisions claim, which can be up to a year from the death of the member!

So, while waiting for the expiration of a family provisions claim period, what is the status of the SMSF? *Non-complying – see above!*

And you might be thinking that this would never happen, but here's the deal, if you do not plan and prepare for the worst and worst happens, you could be looking at a long, drawn out, expensive and nasty legal argument - particularly if there is a family provisions claim.

To give you a real life example, at Abbott and Mourly Lawyers we were involved in a family provisions claim, representing the spouse of her late husband who died with a family discretionary trust and SMSF where he was the only director of both corporate trustees and the shareholder. The original lawyers advice at the outset was don't worry the shares will pass to the estate and the Executor, who was not the spouse, but a long time business friend could become the director of the corporate trustee.

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[2] Whether you are using a SMSF Will (my preference) or a BDBN, it is not effective unless there is an option for what will happen in the event the fund is a non-complying fund in the year of the death of the member or while the SMSF is being administered post the death of the member. It should not be an option but a mandatory requirement!

Well, the case went on for three years as the counsel representing one of the deceased's children made a family provision claim on the estate and threatened the Executor with a whole list of wrongs, charges and civil actions if they sought to do anything with the companies without the express approval of their client. It got so bad that the bank, who had a mortgage on a property in the discretionary trust started recovery action against the trustee for failure to repay the loan.

My Advice: Put in place a Successor Director for the SMSF to minimise any litigation and more importantly ending up with a non-complying SMSF. If you would like to know more about how the Successor Director solution works and it's implications I did a one hour webinar which was recorded and can be found here: https://info.lightyeardocs.com.au/supportcentre/29-march-the-successor-director-solution-for-director-replacement

2. A Super Strategy that might surprise you

Jim Jones is 35 years old earns $145,000 per annum and is married with two children who are lovingly cared for by his spouse. He is a successful computer consultant with limited ability to shift income. He is a sole trader and with his business humming along Jim's tax liabilities are significant. For the year ended 30 June 2022 his Xero accounts show projected taxable income of $145,000. On that projection he will pay tax of $39,491 including Medicare. Jim has a house worth $850,000 and a redraw facility of $250,000.

Jim is also the sole member and director of the Jones SMSF with $300,000 in his superannuation benefits all sitting in cash. So good so far and let's hope it is not a single member SMSF and Jim has life insurance in the Fund.

Let's work through a case study where Jim contributes $100,000 of concessional contributions on 27 June 2022 from the equity of his home.

Step One – Personal Deductible Contribution - $100,000

For the income year 2021 – 2022 Jim *makes a personal tax deductible contribution of $100,000*. At the outset this would reduce Jim's taxable income to $45,000 and his tax liabilities for the year ended 30 June 2022 to $5092 – but with a low income tax offset of $325 and low to middle income tax offset of $1,275, his total tax bill for Jim of $3,492.

Step Two – Contributions Tax in the Fund

From the Fund's perspective the $100,000 contributions would be assessable to the Trustee of the Jones SMSF as taxable contributions per section 295-160 of the ITAA 97. Potential tax payable on these contributions (i.e contributions tax) is $100,000 x 0.15 = $15,000.

Contributions Tax Minimisation Strategy: It is important for the Trustee of the Fund to seek to reduce the contributions tax liability in the Fund and for that, the Trustee could do one or more of the following:

1. Interest expenses if the trustee decides to invest to borrow property under a special purpose SMSF loan
2. Invest in shares paying imputation credits – these may also be leveraged using a special purpose SMSF loan

3. Invest in an early stage innovation company where any investment receives a 20% tax offset.

These investments that go to reduce the contributions tax liability in the Fund will bring about an on-going, in some cases, permanent reduction of tax payable in the Fund. The best time for maximising the benefits is to have the contributions capital in from day one not day 364.

Step Three – Add back Excess Concessional Contributions to Jim's personal taxes

Jim's personal income taxation position is as follows:

- Jim can use the catch up provisions that commenced in 2018-2019 as he is under the $500,000 super balance threshold. Over the four year period Jim has contributed $50,000 so his catch up concessional contribution balance for the year ended 30 June 2022 is $102,500 - $50,000 = $52,500
- This means that personal super contributions that are excess concessional contribution: $100,000 - $52,500 = $47,500. This excess is to be added back to Jim's 2022 assessable income upon an amended assessment by the ATO post lodgement of the fund and Jim's personal income tax returns.
- Any excess concessional contribution is a non-concessional contribution using Jim's NCC cap of $110,000 which he is well under.
- Jim's 2022 tax assessment in March 2023 based on current income of $45,000 is $3,492.
- The trustee of the Super Fund lodges its tax return in March 2023 showing concessional contributions by Jim who has lodged the appropriate concessional contribution notice of $100,000.
- An amended Assessment issued by the ATO to Jim personally once the Fund's and the personal income tax returns are married up in order to tax the excess concessional contribution at Jim's marginal tax rate – see section 291-15 of the ITAA 97. There will be an add back of the Excess Concessional Contribution of $47,500 BUT NO ECC Charge as this has been abolished from 1 July 2021.
- The Amended Tax Assessment for Jim is: $47,500 of taxable income which is taxed at 32.5% + 2% Medicare = $16,387.50
- However, section 291-15(b) provides a 15% tax offset on the excess concessional contribution of $47,500 which is $7,125.
- So total tax payable on the $100,000 contribution is $9,262 – there are no other penalties.
- Total tax payable on $145,000 is $7,125 + $3,492 = $10,617 or a 7.3% tax rate.

No Carry Forward Concessional Contributions

- If Jim did not have any carry forward concessional contributions, then his excess concessional contribution would be $72,500 with tax payable on this amount, including Medicare Levy of 2% = $25,012 but with a 15% tax offset of $10,875 with total tax payable in the amended assessment of $14,137.
- Total tax payable on $145,000 is $14,137 + $3,492 = $17,629 or a 12% tax rate.
- *Remember though the tax in the Fund – which is important to minimise!*