Death and Taxes - Property in super – the elephant in the room

Two proposals, to be implemented in unison:

> **Tax current exempt pension income, in the hands of the Superannuation funds, at 7.5% (5% for capital gains), where members have a balance in all of their superannuation accounts in excess of $1,000,000 (to be indexed) at the start of the financial year; and**
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> **Allow lump sum death benefit payments (subject to the trust deed) to remain in the fund, where a Binding Death Benefit Nomination has nominated death benefit dependent individuals and the addition of these new members to the fund does not exceed the maximum 4 members. These superannuation interests would be taxed as accumulation interests until the new members commence a pension in their own right.**

There has been much discussion in the press over the past weeks regarding the draft taxation ruling TR2011/D3 regarding the taxation treatment of superannuation income streams. With the recent release, by the Treasurer, of the Tax Forum Discussion Paper, this is the perfect time to start a discussion regarding an issue close to estate planner's hearts – the issue of death benefits being paid from a superannuation fund where the fund's assets include property.

With the change in the borrowing rules contained in SIS s67(4A), implemented in September, 2007 (and updated in 2010 with changes to s67A & B), self managed superannuation funds (SMSF's) were initially slow to undertake borrowings to acquire real property, in part due to limited borrowing options as the major banks did not have their systems in place to cope with this new product. As more SMSF's pursued the desire to purchase property in their fund, more external banking products became available. The ATO has also clarified a number of matters in relation to the bare trust arrangement required to be established to undertake this form of investment, including where the liability for GST rests in this arrangement, although it is believed that the ATO position is under review.

As accountants and fund administrators, we are seeing more superannuation trustees gearing their property investments. At the same time, we are seeing some 'less suitable' applicants undertaking these property investments in their SMSF's. I say that, from a superannuation administration and tax practitioner view, they are less suitable, because:

1. The trustees use all (or nearly all) of their superannuation balance as the deposit for the property, leaving little for contingency expenses that may arise;
2. The trustee/members may be close to retirement age and are considering commencing a pension – the taxation benefits of gearing will be lost when the fund is no longer paying tax, and the loan repayments will be an additional drain on the cash flow of a fund paying pensions;
3. The term of the loan may also take the members well into their retirement;
4. The repayments on the loan (particularly in relation to residential property) may require the member to continue to contribute to super to meet the shortfall each month – if the member becomes unemployed, this puts increasing pressure on the fund's other assets.

For those trustees who are interested in this form of investment, they need to take extensive advice before adopting this strategy.

The elephant in the room …

There does not seem to be much discussion about what happens to the fund assets, and specifically property, when the members of the fund pass away. Many clients in receipt of pension income from their self managed superannuation funds, where they are aware that they have a terminal illness, are also aware of the taxation benefits of disposing of the assets that represent their member balance while the fund is paying them a pension, as there will be no tax on the profit on disposal of these assets. It is also part of the process of 'tidying their affairs' where they have the luxury of time before their demise.

Not everyone is afforded this luxury, and it is inconsistent that one taxpayer receive an advantage over another taxpayer due to the timing of their death. With this in mind, it would be preferable for there to be a legislative system whereby death benefits could be retained by the fund, to be held for the next generation.

By way of example, Mum and Dad have a business and purchase a commercial property (their business premises) in their self managed superannuation fund through a small borrowing facility and everything goes well for a number of years – the business pays the rent, the loan is repaid over a few years and the investment is producing solid returns for the fund. Both Mum and Dad then retire and are receiving pensions from the fund - and then, suddenly, Dad passes away. The transition of his member balance to his wife is seamless – the fund has a corporate trustee, so Mum can continue to be the sole Director of the trustee company and sole member and, as Dad's pension was reversionary to Mum, Mum continues to benefit from her now 100% interest in the fund.

What happens when Mum passes away?

Mum and Dad have 3 adult children, and Mum, in her Binding Death Benefit Nomination, has left a 1/3 interest in her member balance to each child. How do you split a property 3 ways? The options are limited, subject to provisions in the trust deed:

1. The building can be sold to a third party for market value, and then the proceeds (net of tax) can be paid as a lump sum to the beneficiaries, after the 16.5% tax is withheld on the taxed component of the balance ;
2. If one of the children wanted to acquire the property from the fund at market value, they could lend for the purchase of the asset and then the fund could pay a lump sum death benefit (as per 1 above) and the child could then use their share of the death benefit proceeds (net of tax) to pay down part of the loan. This option is dependent upon the related party having sufficient resources to pay the stamp duty and legal fees on the transfer, as well as meeting the bank's deposit requirements.

Had there still been a loan secured by the building at the date of death of both Dad and Mum, this would have further complicated the matter.

There are significant benefits to their being a death benefit nomination form in place, as the balance of the member's benefit does not need to be paid to the estate, where it could be subject to legal proceedings where a will is challenged. Also, any movement of the property out of the fund will incur stamp duty for the purchaser, as there will be a change of ownership.

There is also a change in the taxation position of the fund from Mum's date of death to the date the building is disposed of, which draft ruling TR 2011/D3 confirms will be a taxable event (capital gains tax at the rate of 10% will be paid on the gain on disposal, assuming the property was purchased post 19 September, 1985). When the capital gains tax has been calculated, the legal and accounting fees paid and the fund's tax returns lodged, the beneficiaries will have an idea of what their entitlement will be.

There must be a better option.

If the government is serious about providing long term retirement benefits for it's citizens, one option is to allow assets to be retained in the superannuation environment after the death of a member, where there is no spouse, child under 18 or financial or interdependent tax dependent available to receive a lump sum or pension. The leakage to government in the form of tax and stamp duty payments is non productive and encourages the reduction in value of these superannuation assets where they are required to be sold to pay the estate or individual death benefits – where individuals receive cash it may be easily dissipated. Bankruptcy and family law disputes add to the many ways that funds outside the superannuation environment can be exposed to claims.

With the increase of property purchases in the SMSF area, the issue of extracting property from a fund will only increase over time. The option of leaving assets within a fund and allowing new members to come into the fund encourages the retention of assets to generate future revenue, allowing the next generation to 'self fund' their own retirement. The government will continue to receive the 15% tax on the income generated by the investments while they remain in the fund, up to the time that the members convert their interests into a pension interest.

This change would require all of the existing fund trust deeds to be updated, supported by legislative change. This would be a small price to pay to give trustees an option of leaving their assets to the next generation intact.

This takes me to the second proposal – taxing superannuation pension interests for those with a balance in excess of $1,000,000. There are many superannuation funds in 'pension mode' with significant, income generating assets, and in some cases the member balances require annual pension payments be made in the hundreds of thousands of dollars.

There are considerable benefits for members and the government for the funds to be retained in a superannuation environment.

The ATO has the ability, through the information supplied in fund income tax returns each year, to determine the number of funds that this proposal would apply to and the income that would be generated by the proposal.

The current benefit for those over 60 years of age receiving superannuation pensions is that they are not subject to tax – they are not included on the individual's annual income tax return. An individual can structure their affairs to pay no tax in their superannuation fund, and pay no personal tax, where the bulk of their income comes from their superannuation pension.

While these taxpayers are in a position to pay no personal tax, they are still able to utilize all government services - the health system, the police, defence, border security, roads and infrastructure etc.

The proposal that the SMSF pay a concessional rate of tax when the fund's assets are paying a pension is simple and cost effective – superannuation funds already lodge an income tax return each year and pay at least the ATO levy (where part of the assets of the fund are not supporting a pension, the fund will also have a tax liability at 15% on that part of the fund). The individual member's personal tax position is unchanged (many may not need to lodge a tax return from the 2012/2013 year) and if the rate of tax is 7.5% and 5% as proposed, this is the most concessional rate (apart from zero) that the taxation system has to offer. Having a minimum member balance that this would apply to will allow for a carve out for those with a reasonable level of superannuation savings, and individuals will still have the flexibility of rearranging their affairs if they are close to the threshold where they can achieve a lower average tax rate, they will rearrange their affairs accordingly.

I appreciate that the opponents of this proposal will say that the pensioners with in excess of $1m in their superannuation balance have contributed to the tax system all of their working lives, so their retirement benefits should be tax free. All of us are living longer. Considering many start work at age 20 and work until age 55, that 35 years of contribution will soon be matched, on average, by 35 years of retirement until we pass away. It would be difficult for any country to provide all of the infrastructure and services for their citizens, to the level that we currently enjoy, where a large proportion of the population is contributing little or nothing to tax collections, especially considering Australia's birth rate and reduced migration intake. The argument that retiree's will continue to be consuming, and so are contributing via the GST is correct, but as any ageing person will confirm, as you get older, your needs become simpler and you have less need (and often less resources and desire) to consume. So, a self funded retiree's contribution to the tax cake continues to diminish over time, especially where their outgoings are medically related and potentially not subject to GST.

If the government is genuine in looking for a long term option to retain assets within the protected superannuation environment and for some superannuation funds to continue to contribute to the revenue pool, this is one suggestion to be put on the table. In discussing superannuation matters with my peers, I am well aware that there are many good ideas that should be explored as part of a long term, stable reform to the superannuation system – it's time the tax profession, and not the politicians, were heavily involved in the discussion.

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