# MANAGING THE SMSF LIQUIDITY PROBLEM

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## Natasha Panagis

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Natasha is a Technical Manager for AIA Australia's Technical Education Centre of Excellence (TECE) Team. Her experience includes providing technical and strategy support to financial advisers on a broad range of wealth management areas, from superannuation through to taxation, estate planning, insurance, social security and aged care planning.

Prior to joining AIA Australia, Natasha was a Technical Manager at Aged Care Steps and Strategy Steps.

Natasha's qualifications include a Bachelor of Business (Management), a Bachelor of Business (Applied Finance) and an Advanced Diploma of Financial Services (Financial Planning). She is also a Certified Financial Planner® (CFP), a SMSF Specialist Advisor™ (SSA) and a registered Tax (Financial) Adviser.

## Agenda

- SMSF insurance strategy requirements
- How insurance provides liquidity to pay death / disability benefits
- Challenges for unrelated business owners

## Setting the scene

**SMSF asset allocation statistics**

- **$746b in assets** — SMSFs make up 25% of all super assets
- **$43b in LRBAs** — LRBAs represent 5.8% of total SMSF assets
- **>90% of LRBAs are in property** — Property main asset for borrowing
- **13% of SMSF assets in property** — Total property inv lower than other asset classes
- **31% shares & 21% cash & TDs** — Listed shares & cash/TDs top assets held

## SMSF insurance strategy considerations

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## SMSF investment strategy requirements

SMSF trustees required to regularly review and formulate an investment strategy that gives regard to all the circumstances of the fund, including:

**whether the trustees should hold a contract of insurance that provides insurance cover for one or more members of the fund**

Regular review = at least annually

Penalty for breach = $4,200 to corporate trustee or to each individual trustee (up to $16,800)!

### Points to consider when determining member's insurance needs

Trustees need to prove they have considered insurance needs of members annually


## Documenting whether a member requires cover

Once issues considered, trustees should document decision which:

- Acknowledges trustees are aware of obligation to consider insurance cover
- Shows trustees have considered the need for insurance cover for each member
- Confirms trustees have implemented cover to meet needs of individual members, or
- Acknowledges trustees have determined whether insurance is required for members

## Documenting why a member may not require cover

Trustees should also document reasons why insurance cover is not required, such as:

- Members have adequate insurances in place elsewhere
- Members have significant assets in excess of liabilities (if any)
- Members happy to accept risk of being uninsured
- Members don't believe in insurance or don't want premiums impacting their retirement savings
- Trustee unable to obtain affordable life insurances due to the members' health or age

## Key takeaways – insurance checklist

1. • Check trust deed – does it allow trustee to acquire insurances for members?
2. • Ensure trustee considers insurance needs of members annually and documents decision
3. • Ensure insurance policy definitions align with SIS condition of release
4. • Ensure policy is owned by trustee on behalf of member and paid for by SMSF
5. • Refer client/SMSF trustee to qualified insurance adviser if inexperienced or don't hold AFSL to provide advice

## Insurance strategies to create liquidity to SMSFs

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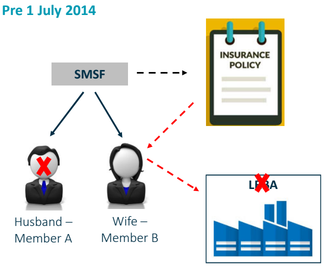
## Using insurance for liquidity purposes

- Liquidity strategy especially relevant where:
  - Large lumpy asset
  - LRBA exists and cash flow is critical
- What are potential solutions? (pension payments, sell asset or transfer in-specie, bring in new fund members)
- Insurance may be solution – structuring correctly is key
- Insurance can be used to:
  - Boost member's account balance
  - Allow fund to retain large asset without having to sell down
    - Repay debt – cash flow
    - Provide cash replacement for assets in benefit payment – liquidity

## Past practice – what we were doing

**Pre 1 July 2014**




SMSF takes out insurance policy on each member

Premiums paid from:

- Other member's (non-life insured) account, OR
- SMSF reserve account

Upon death/disability, proceeds credited to that member's account / reserve account to repay debt or pay death benefit without selling asset

## Current practice

**SISR and ATO view**

Cross insurance and reserve strategies not permitted from July 2014

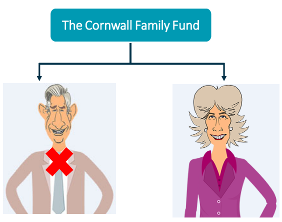
Reg 4.07D(2) of SISR 1994:

- Fund must not provide an insured benefit in relation to a member unless the insured event is consistent with a COR

ATO view (SMSFRB 2018/1):

- ATO concerned strategy is inconsistent with the SPT where purpose of policy is to satisfy other trustee obligations, eg. extinguish debt under a LRBA, rather than increase the member's interest (ie. to pay a death benefit)

## Case study 1 – Charles & Camilla




Facts:

- Charles (67) & Camilla (62)
- SMSF purchased BRP for $2.5m in 2016
- BRP funded from SMSF cash & LRBA of $500k
- SMSF owns $500k life & TPD cover for both
- Both in accumulation phase
- Charles dies in Feb 2020
- Death benefit payable to Camilla

## Charles & Camilla

### Pre vs post death member balances

| The Cornwall Family SMSF | Pre death | Post Charles death |
|---|---|---|
| Cash | $200,000 | $700,000 (includes $500k life proceeds) |
| Business real property | $2,500,000 | $2,500,000 |
| LRBA (20% LVR) | ($500,000) | ($500,000) |
| **Total net assets** | **$2,200,000** | **$2,700,000** |

Charles & Camilla's current member balances are $1.1m each (ie. 50% each)

After Charles death, his member balance is $1.6m ($1.1m + $500k life insurance). Camilla has $1.1m

Liquidity problem!

## Polling question #1

### Charles & Camilla

## Charles & Camilla

### Strategy #1 – cash for asset swap

- Trustee decides to pay death benefit income stream to Camilla
- Use cash injection from insurance to reduce loan – cash for property swap (ie. property fully backs Camilla's interest)

| The Cornwall Family Fund | Upon Charles death | Death benefit pension paid |
|---|---|---|
| Cash | $700,000 (includes $500k life proceeds) | $200,000 |
| Business real property | $2,500,000 | $2,500,000 |
| LRBA | ($500,000) | $0 |
| **Total net assets** | **$2,700,000** | **$2,700,000** |

- Camilla's total member interest = $2.7m ($1.1m accumulation + $1.6m death benefit pension)

## Charles & Camilla

**Paying Camilla's death benefit pension**

| Cash flow assumptions | Amount |
|---|---|
| Cash interest @ 2% | $4,000 |
| Plus gross annual rent received @ 5% | $125,000 |
| Less annual running costs (rates, water, insurance, repairs, admin fees, etc) | $10,000 |
| **Gross cash flow** | **$119,000** |

Required annual min ABP payment = $64,000 ($1.6m x 4%)

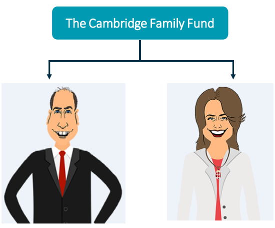
SMSF has enough liquidity (rent) to pay min pension (+ other costs, taxes, etc)

## Charles & Camilla

**What if circumstances were different?**

- Assume limited cash flow in fund – trouble meeting min ABP payments (or LRBA repayments)
- How can death benefit be paid if liquidity problems exist?
- Considerations / options:
  1. Pay partial death benefit lump sum via in-specie transfer of an interest in the property to Camilla, or
  2. Introduce new members into the fund (eg. Children) to help inject funds and meet any liquidity issues of the SMSF, or
  3. Sell property to pay death benefit

## Case study 2 – William & Catherine




Facts:
- William & Catherine (both 38)
- SMSF purchased BRP for $1m in 2019
- BRP funded from SMSF cash & LRBA of $600k
- SMSF owns $1m life & TPD cover for both
- William earns $150k pa
- Catherine not working

## William & Catherine

### Current member balances

| The Cambridge Family Fund | Amount |
|---|---|
| Cash | $100,000 |
| Business real property | $1,000,000 |
| LRBA (60% LVR) | ($600,000) |
| **Total net assets** | **$500,000** |

As at 30 June 2019, their member balances are:

- William: $300,000 (60%)
- Catherine: $200,000 (40%)

## William & Catherine

### Current SMSF cash flow

| Cash flow assumptions | Amount |
|---|---|
| Concessional contributions | $25,000 |
| Plus cash interest @ 2% | $2,000 |
| Plus gross annual rent received @ 5% | $50,000 |
| Less annual running costs (rates, water, insurance, repairs, admin fees, etc) | ($8,000) |
| Less LRBA repayment (P&I @ 6% over 15 years) | ($60,770) |
| **Gross cash flow** | **$8,230** |

However William becomes TPD and meets permanent incapacity COR in Feb 2020. Implications?

## William & Catherine

### Impact of post 1 July 2018 LRBA changes

William meets full COR (permanent incapacity)

Must include outstanding LRBA amount attributable to his super interest in his TSB calculation

Their revised TSB will be:

| The Cambridge Family Fund | William | Catherine |
|---|---|---|
| Member balance | $300,000 | $200,000 |
| TPD insurance proceeds | $1,000,000 | - |
| Share of LRBA | $360,000 | - |
| **Total super balance** | **$1,660,000** | **$200,000** |

## Polling question #2

William & Catherine

## William & Catherine

Strategy #2 – options to consider

**1. Retain TPD benefit in super**

- Can retain TPD benefit in fund (unlike death benefit)
- William's member benefit can be used to fund shortfall ($17k), or reduce/repay LRBA

**2. Make contributions to super**

- No NCCs for William (as TSB > $1.6m)
- Catherine can make catch up conts & NCCs to cover shortfall

## William & Catherine

Strategy #2 – options to consider

**3. TPD lump sum**

- $1m TPD benefit = 100% taxable component
- $220k tax withheld by fund (22% tax rate)
- Tip – TPD tax break available (can save up to $132k in tax!)

**4. TPD pension**

- Pension taxable @ MTR but 15% tax pension offset available
- Can draw approx. $121k pension pmt to have same net income (replace $150k salary)
- TPD tax break only available if rollover to another fund

## Challenges for unrelated business owners

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## Case study – William & Thomas

**Unrelated business owners/partners in SMSF**

The NailedIt Fund

Facts:

- William & Thomas are business partners & trustees of their SMSF
- SMSF purchased BRP for $800k in 2019 that is leased to their housing construction company
- BRP funded from SMSF cash & LRBA of $400k
- They want $400k of life/TPD to cover the LRBA each
- Can insurance help with their LRBA?

## William & Thomas

**Current member balances**

| The NailedIt Fund | Amount |
|---|---|
| Cash | $100,000 |
| Business real property | $800,000 |
| LRBA (50% LVR) | ($400,000) |
| **Total net assets** | **$500,000** |

As at 30 June 2019, their member balances are:

- William: $250,000 (50%)
- Thomas: $250,000 (50%)

## William & Thomas

### Current SMSF cash flow

| Cash flow assumptions | Amount |
|---|---|
| Concessional contributions | $50,000 |
| Plus cash interest @ 2% | $2,000 |
| Plus gross annual rent received @ 5% | $40,000 |
| Less annual running costs (rates, water, insurance, repairs, admin fees, etc) | ($7,000) |
| Less LRBA repayment (P&I @ 6% over 15 years) | ($40,510) |
| **Gross cash flow** | **$44,490** |

However Thomas dies in Feb 2020. Implications?

## William & Thomas

### Strategy #3 – own insurance outside SMSF

1. Hold $400k life insurance policy outside SMSF – ie. cross ownership

2. William uses proceeds to make $400k NCCs to SMSF – $100k in 2019/20 and $300k in 2020/21

3. SMSF uses NCCs to pay Thomas' death benefit ($250k) & reduce LRBA (by $150k)

| The NailedIt Fund | Pre Thomas' death | After Thomas' death (July 2020) | After death benefit paid |
|---|---|---|---|
| Cash | $100,000 | $500,000 (incl $400k NCCs) | $100,000 |
| BRP | $800,000 | $800,000 | $800,000 |
| LRBA | ($400,000) | ($400,000) | ($250,000) |
| **Total net assets** | **$500,000 ($250k member interest each)** | **$900,000 ($250k Thomas' death benefit $650k William's interest)** | **$650,000 (100% William's interest)** |

## Polling question #3

### William & Thomas

## Liquidity checklist:

Will liquidity be a problem in the event of a member's death or disability?

- ❑ Is there a need to retain the asset?
- ❑ Can benefit be paid out at all?
- ❑ Can benefit be paid out in-specie?
- ❑ Can benefit be paid out as a pension?
- ❑ If LRBA, can repayments still be funded?
- ❑ How much insurance is necessary? What can be achieved?
- ❑ Will insurance proceeds pay off loan and/or boost fund balance and/or improve cash position?
- ❑ Can member make contributions to super (ie. Consider age, TSB, available cap space, etc)?
- ❑ What is impact on long term investment strategy of fund?
- ❑ Alternatives to SMSF borrowing?
- ❑ Other impacts?

## Wrap up

**Key takeaways**

1. Ensure your clients SMSF insurance strategy meets the rules
2. Insurance can help provide liquidity for lumpy/illiquid assets, BUT
3. Invest with the end in mind – how will property be disposed of?

## Disclaimer



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