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Dealing with death – better the devil you know!

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Contents

Case study 1a : Trustee restructure needed? Member who is 1 of 2 trustees dies 3

Case study 1b : Trustee restructure needed? Member who is 1 of 2 directors of corporate trustee dies 6

Case study 1c : Trustee restructure needed? Member, whose LPR (EPoA) was acting in their place as trustee, dies 8

Case study 1d : Trustee restructure needed? Sole director / sole shareholder of corporate trustee dies 10

Case study 1e : Appointment powers (deadlock) 11

Case study 1f : Shareholder powers (jointly held shares) 13

Case study 2 : Death of a member in receipt of a pension 15

Case study 3 : How can receipt of a death benefit affect the financial arrangements of a non-death benefits dependant beneficiary? 18

Case study 4 : Is everything going to play out as you'd planned? Some new things to consider 22

Case study 1a : Trustee restructure needed? Member who is 1 of 2 trustees dies

Charles (67) and Camilla (62) are the individual trustees, and sole members, of an SMSF.

Camilla has just died.

Question 1

Aside from the SMSF definition [SIS Reg 17A], what other rules / laws should Charles be cognisant of?

Answer

The governing rules of the SMSF. These will prescribe various things including for example:

- Whether there are any particular rules about trustees (eg minimum number),
- Whether a member's legal personal representative can act as a trustee in place of the member during their lifetime and after their death (including whether multiple legal personal representatives can act as a trustee in place of a single member),
- When membership of a deceased member ceases,
- Who has power to appoint a new trustee (and also remove a trustee)? And how must any appointment (removal) be effected?

Question 2

Does Camilla's membership cease on her death?

Answer

Not necessarily, it will depend on the governing rules of the SMSF. It is not unusual for membership to continue until, say, such time that:

- The death benefits **commence** to be paid, or
- All of the death benefits are to be dealt with.

Question 3

Regardless of whether Camilla's membership ceases on death, or at a later time, her trusteeship ceases on death and the SMSF has a single individual trustee from that time.

If the trustee needs to be restructured in order for the SMSF definition to be met, what timeframe applies to the restructure?

Answer

An SMSF generally has a six month period during which it might technically fail the SMSF definition following the death of a member / trustee (or director of a corporate trustee), however, such failure will be disregarded. This effectively provides some time to restructure and remain an SMSF [SIS s.17A(4), SIS s.17A(5)].

In this case, Charles needs to restructure the trustee by the 6 month anniversary of Camilla's death in order to not fail to meet the SMSF definition.

Question 4

What options are available to Charles in relation to restructuring the trustee if Camilla's membership ceased when her death benefits commenced to be paid, if this occurred:

a. Within 6 months of her death?
b. More than 6 months after her death?

And where, if anywhere, does Camilla's executor (her LPR) fit in? Do they need to be factored in to the restructure?

Answer

a. For 6 months from Camilla's death, the SMSF will not fail to meet the SMSF definition if it has a single individual trustee (Charles). By the 6 month anniversary of Camilla's death (at the latest), Charles must either:

   - Appoint another individual trustee (ie "other" trustee), or
   - Change the trustee to a corporate trustee. This company could have either 1 director (Charles) or 2 directors (Charles and another person – the "other" director).

   The "other" trustee / director could be anyone – it **could** even be one of Camilla's executors (ie LPR), however, the LPR could not be the "other" trustee / director in their LPR capacity representing Camilla, rather they would simply be the "other" trustee / director of a single member SMSF in their own capacity.

b. Camilla would still be a member of the SMSF on the 6 month anniversary of her death – remember her membership ceases after this time.

   By the 6 month anniversary of Camilla's death (at the latest), Charles must either:

   - Appoint one (or more) of Camilla's executor(s) as the "other" individual trustee(s), or
   - Change the trustee to a corporate trustee. This company should at least 2 directors, ie Charles and one (or more) of Camilla's executor(s).

   Once Camilla's membership ceases, Charles may wish to restructure the trustee again. The SMSF will then only have a single member (himself) and the trustee structure should be comprised of:

   - 2 individual trustees, ie Charles and another individual, or
   - A corporate trustee with either a single director (Charles) or 2 directors (Charles and another person).

   The "other" trustee / director could now be anyone – one of Camilla's executors could even remain as the "other" trustee / director, however, they would no longer be acting in their LPR capacity representing

Camilla, rather they would simply be the “other” trustee / director of a single member SMSF in their own capacity.

Case study 1b : Trustee restructure needed? Member who is 1 of 2 directors of corporate trustee dies

Charles (67) and Camilla (62) are the directors of the corporate trustee, and sole members, of an SMSF.

Camilla has just died.

Question 1

Aside from the SMSF definition [SIS Reg 17A], what other rules / laws should Charles be cognisant of **right now**, even before he considers whether restructuring the trustee is needed?

Answer

Both:

- the Corporations Act : it requires a minimum of 1 director, and that director must be domiciled in Australia, and
- the Company's constitution. Can the Company have a single director?

Question 2

Charles is domiciled in Australia and the constitution allows a single director.

Would the corporate trustee need to be restructured if Camilla's membership ceased when her death benefits commenced to be paid, if this occurred:

a. Within 6 months of her death?
b. More than 6 months after her death?

Answer

a. For 6 months from Camilla's death, the SMSF will not fail to meet the SMSF definition if it has a single director of the corporate trustee.

   Once Camilla's membership ceases, the SMSF will be a single member SMSF with a sole director.

   No restructuring of the corporate trustee is **required**.

   Camilla's LPR(s) could be appointed as a director in her place from her date of death up until the time her death benefits commenced to be paid – but this is an option only, it is not required in order for the SMSF definition to be met.

b. Camilla would still be a member of the SMSF on the 6 month anniversary of her death – remember her membership ceases after this time.

By the 6 month anniversary of Camilla's death (at the latest), one (or more) of Camilla's executor(s) must be appointed as a director of the corporate trustee.

Once Camilla's membership ceases, Charles may wish to restructure the trustee again. The SMSF will then only have a single member (himself) and the corporate trustee structure could be comprised of:

- either a single director (Charles),
- or 2 directors (Charles and another person).

The "other" director could now be anyone – one of Camilla's executors could even remain as the "other" director, however, they would no longer be acting in their LPR capacity representing Camilla, rather they would simply be the "other" director of a single member SMSF in their own capacity.

Case study 1c : Trustee restructure needed? Member, whose LPR (EPoA) was acting in their place as trustee, dies

Charles (67) and Camilla (62) are the members of an SMSF.

Camilla had granted an Enduring Power of Attorney (EPoA) to her daughter Laura. Camilla had resigned as an individual trustee, and was replaced as an individual trustee by Laura.

The current trustees of the SMSF are Charles and Laura.

Camilla has just died.

Laura is not Camilla's executor.

Question 1

Now that Camilla has died, is Laura still her LPR?

Answer

No.

The LPR of a deceased person is their executor or the administrator of their estate. The EPoA granted to Laura by Camilla only had effect while Camilla was alive.

Question 2

As Camilla was not an individual trustee, does the trustee need to be restructured if Camilla's membership ceased when her death benefits commenced to be paid, if this occurred:

a. Within 6 months of her death?
b. More than 6 months after her death?

Answer

a. From the date of Camilla's death, up until the date her death benefits commenced to be paid (and her membership ceased) the SMSF had 2 members and 2 trustees – one trustee (ie Laura) was not a member nor the LPR of a deceased member. The SMSF will not fail to meet the SMSF definition during this time as this period was within 6 months of Camilla's death (ie because of the 6 month rule).

   Camilla's LPR(s) (executor(s)) **could**, however, have been appointed as an individual trustee(s) during this period of time (note this is an **option**, not a requirement), but Laura would need to resign / be removed as an individual trustee first. If this had occurred , one of Camilla's executors could even remain as the "other" trustee after this time, however, they would no longer be acting in their LPR capacity representing Camilla, rather they would simply be the "other" trustee of a single member SMSF in their own capacity.

In addition, Laura could have simply remained in place with her role revised to the “other” trustee of a single member SMSF in their own capacity.

b. Camilla would still be a member of the SMSF on the 6 month anniversary of her death – remember her membership ceases after this time.

By the 6 month anniversary of Camilla’s death (at the latest), one (or more) of Camilla’s executor(s) must be appointed as an individual trustee and Laura must resign / be removed.

Once Camilla’s membership ceases, Charles may wish to restructure the trustee again.

The SMSF will then only have a single member (himself) and the trustee structure could be comprised of:

- 2 individual trustees, ie Charles and another individual, or
- A corporate trustee with either a single director (Charles) or 2 directors (Charles and another person).

Case study 1d : Trustee restructure needed? Sole director / sole shareholder of corporate trustee dies

Charles is the sole director and sole shareholder of the corporate trustee of a single member SMSF.

He dies and the SMSF is to be wound up.

Question 1

Who has the power to appoint a director in cases where the company had a single director / single shareholder? And when should a new director be appointed?

Answer

The Corporations Act prescribes that the deceased's LPR has the power to appoint a director. Note that this rule cannot be displaced by the constitution of the company, ie it is not a replaceable rule.

A new director must be appointed ASAP.

Question 2

Does the new director have to be Charles' LPR?

Answer

No. The new director can be anyone. And if Charles' membership of the SMSF ceases within 6 months of his death, the SMSF definition will not fail to be met despite the director not being Charles' LPR.

Question 3

The governing rules prescribe that Charles' membership will cease once the death benefits commence to be cashed. If this is more than 6 months after Charles' death, who must be the director of the corporate trustee in the period:

- Starting 6 months after Charles's death, up to
- The date his death benefits commence to be cashed?

Answer

As this is outside the "6 month rule" time period, the SMSF definition will only be met if Charles' executor(s) are the director(s) of the corporate trustee from the "6 month mark".

Case study 1e : Appointment powers (deadlock)

William & Harry are the directors (and shareholders – 1 ordinary share each) of the corporate trustee of their SMSF.

William's executor is his wife Kate, while Harry's is his wife Meghan.

The sole asset of the SMSF is a property (acquired under an LRBA, with an outstanding loan balance).

Harry dies, and his death benefit will be paid in pension form to Meghan. She will need to become a member of the SMSF.

In order to meet the SMSF definition, Meghan (or her LPR in her place) will also need to become a director of the corporate trustee.

Question 1

Who has the power to appoint a director? (Assume the Company constitution does not displace the replaceable rules in the Corporations Act).

Answer

Under the Corporations Act:

- Directors can appoint a director, or
- Shareholders can appoint a director.

Question 2

William (as sole director) refuses to appoint Meghan as a director. Can the shareholders instead appoint Meghan as a director?

Answer

While Meghan (as Harry's executor) is able to exercise Harry's shareholder voting powers (he held 50% of the shares), Meghan's appointment as director relies on William voting in favour of her appointment. If William is not prepared to appoint Meghan as a director in his director capacity, he is unlikely to vote in favour of her appointment at the shareholder level.

There's likely to be a deadlock!

Question 3

With hindsight, what planning steps could you have identified – prior to Harry's death – to prevent this deadlock?

Answer

In some cases, special "appointment clauses" are used in a constitution to:

- Give each shareholder the power to appoint a director, but thereafter

- All director decisions must be unanimous.

This would have enabled Meghan (as Harry's executor) to exercise Harry's shareholder power to appoint herself as a director.

Case study 1f : Shareholder powers (jointly held shares)

Charles, William & Harry are the directors of the corporate trustee of their SMSF and the sole members of the fund.

Charles is the sole shareholder (2 shares).

Charles dies.

The shares in the corporate trustee form part of the "remainder" of Charles's estate and are passed to William & Harry.

Camilla is Charles' executor.

The constitution does not displace the replaceable rules in the Corporations Act and consequently:

- Directors can appoint a director, or
- Shareholders can appoint a director.

Question 1

Who has the power to exercise the shareholder's voting rights?

Answer

Camilla (as Charles' executor) is able to exercise Charles' shareholder voting powers (he held all the shares) until such time that the shares pass to William & Harry.

Once ownership of the shares has passed to William & Harry, if the registry office records the shares as being held jointly, unless the constitution states otherwise, only the first named shareholder can vote (and the name of the eldest person appears first by default). This means that William has more control than Harry!

Question 2

With hindsight, what planning steps could you have identified – prior to Charles' death – to ensure equality in terms of "power" for both William & Harry?

Answer

Charles could incorporate a specific bequest in his will in relation to his shares in the corporate trustee. For example, he could bequest "an equal number of shares" to each of William and Harry.

Doing so would mean that William can't **solely** control appointment (and removal) of directors. Note, however, that they'd still need to agree (as they'd each have equal voting rights).

Alternatively, depending on the governing rules of the SMSF:

- if Charles' membership did not cease on death,
- the majority of members (where the number of votes each member had was based on the size of their account balance(s)) had the power to remove and appoint a trustee,
- Camilla had power to exercise Charles' voting rights, and
- Charles' balance(s) comprised the majority of the SMSF,

Camilla could remove the existing corporate trustee and replaced it with a new one. If this was the case, the new corporate trustee could be established in such a way that William & Harry have equality in terms of "power".

Case study 2 : Death of a member in receipt of a pension

Camilla (62) had been in receipt of an account-based pension when she died on 31 January 2020. The account balance of this pension on 30 June 2019 was $1.7m, and the minimum pension for 2019/20 had been calculated as $68,000 (ie 4% x $1.7m).

Days in 2019/20 : 366. Comprised of:

- 1 July 2019 to 31 January 2020 : 215
- 1 February 2020 to 30 June 2020 : 151

The value of Camilla's pension when she died was $1.62m.

Question 1a

If Camilla's pension had reverted to Charles (67) on her death, how would this effect the minimum pension payments required for 2019/20?

Answer

There would be no change to the minimum calculated on 1 July 2019, ie the minimum of $68,000 calculated on 1 July 2019 would remain in place for 2019/20.

This is because the superannuation law prescribes that the minimum pension is only ever calculated on:

- The commencement day of the pension, and thereafter
- Each 1 July.

Question 1b

Camilla had drawn $10,000 in pension payments in 2019/20 prior to her death. Does this create any issues?

Answer

No.

As long as the **aggregate** of the pension payments drawn by:

- Camilla prior to her death, and
- Charles from Camilla's death up to 30 June 2020

equate to at least $68,000, the minimum pension requirements will be met.

It is completely irrelevant that Camilla had only drawn pension payments of $10,000 prior to her death. She could have drawn nothing prior to her death - there is **no requirement** for any pro-rated pension payments to be drawn prior to a member's death. The critical issue for a reversionary pension is the position at 30 June – not part-way through the year.

Question 1c

How much must Charles draw in pension payments from his reversionary pension by 30 June 2020?

Answer

The minimum calculated on 1 July 2019 of $68,000 less the $10,000 drawn by Camilla prior to her death (ie $58,000).

Question 2

If Camilla's pension had instead been non-reversionary (ie it ceased to be paid on her death), how does this effect the minimum pension payment requirement for 2019/20?

Answer

In cases where a pension is non-reversionary, the superannuation law includes a special exception to meeting the minimum in the year of the pensioner's death. In these cases, it is not uncommon for a pensioner who usually draws all of their minimum pension towards the end of the year to die without drawing any pension payments at all in the year of their death.

Question 3

If Camilla's account-based pension had been reversionary to Charles, what effect would this have on the tax exemption on the SMSF's income in 2019/20? Assume that Charles made no changes to his own pension, nor were any lump sum death benefits paid from Camilla's pension, during 2019/20 (ie ignore Charles' transfer balance cap).

Would the method of calculating the tax exempt investment income change for 2019/20 as a result of Camilla's death?

Answer

If Camilla's account-based pension had been reversionary to Charles, this would have no effect on the tax exemption on the SMSF's income in 2019/20.

As Camilla's pension had been in retirement phase prior to her death, the tax exemption on the investment income generated by assets supporting her pension balance prior to her death would continue to apply after her death – this is because the **same pension** remains in place, the only change is that ownership has been transferred to Charles.

In addition, Camilla's death would not effect the method used by the SMSF to calculate the tax exempt investment income (ie segregated method or actuarial certificate method) in 2019/20. This is because the method(s) to be used in a particular income year are determined based upon whether any member of the SMSF had **both** a retirement phase pension and a total superannuation balance of more than $1.6m at the **previous** 30 June. While a reversionary pensioner will "own" the reversionary pension balance immediately upon the deceased pensioner's death, it will not be included in the reversionary pensioner's total superannuation balance until 30 June of the year of death – their position at the *previous* 30 June will not be effected.

If Camilla's pension had instead been a pre-retirement pension (ie the SMSF was **not** eligible for a tax exemption on the investment income generated by assets supporting her pension balance), the pension will move to

retirement phase upon Camilla's death, and the SMSF will be eligible for a tax exemption on the investment income generated by assets supporting the reversionary pension balance from the date of Camilla's death.

Question 4

If instead Camilla's account-based pension had not been reversionary to Charles, what effect would this have on the tax exemption on the SMSF's income in 2019/20?

Answer

If Camilla's pension had been in **retirement phase** prior to her death, the tax exemption on the investment income generated by assets supporting her pension balance prior to her death would continue to apply:

- From the date of Camilla's death, until
- such time that the death benefits from Camilla's retirement phase pension were dealt with.

Note that the tax law was amended in December 2018 (with effect from 2012/13) to remove the "as soon as practicable" cashing requirement to retain the tax exemption on investment income. This means the tax exemption that applies to a non-reversionary retirement phase pension will continue to apply right up until the time the death benefit is cashed.

Case study 3 : How can receipt of a death benefit affect the financial arrangements of a non-death benefits dependant beneficiary?

When Charles dies, he wants to ensure that William and Harry each receive precisely the same amount in death benefits from Charles' superannuation (he wants to prevent any dispute / disharmony). To this end, he wants them to each receive the same amount "in the hand after tax". Charles is also concerned about how the receipt of a lump sum death benefit from his superannuation could effect:

- other "costs" that could be imposed on, and
- other "benefits" that could be lost for

William and Harry.

William is an adult and is financially independent of Charles. He is an Australian resident for tax purposes and his assessable income (excluding any taxable component of a lump sum death benefit) is $200,000 (from salary and investment income). He has $10,000 of tax deductions. He fully uses his concessional contributions cap each year through a combination of SG contributions and salary sacrifice contributions.

Harry is an adult and is financially independent of Charles. He is a **Canadian** resident for tax purposes and his Australian assessable income (excluding any taxable component of a lump sum death benefit) is $Nil. He has no Australian tax deductions. No contributions are made by Harry to any Australian superannuation fund.

Question 1

If a lump sum death benefit is paid directly to each of William and Harry from Charles' SMSF, how would you calculate how much each will receive "in the hand" (ie after Australian tax and other costs imposed on the taxable component of the LS death benefit, or because of it)?

Assume they each receive a lump sum death benefit of $1m (all taxable component).

Answer

		William	Harry
Other income assessable in Australia (ie salary, investment income etc)		$0.20m	$Nil
Taxable portion of LS death benefit received (gross)		$1.00m	$1.00m
Deductions		($0.01m)	$Nil
Taxable income		$1.190m	$1.00m
Tax payable on taxable income	A	$508,597	$431,550
Taxable income **excluding** taxable portion of LS death benefit received		$0.190m	$Nil
Tax payable on taxable income **excluding** taxable portion of LS death benefit received	B	$58,597	$Nil

Prima facie tax payable on taxable portion of LS death benefit received	A - B	$450,000	$431,550
Maximum tax payable on taxable portion of LS death benefit received (15% x $1m)		$150,000	$150,000
Tax offset		$300,000 (ie $450,000 - $150,000)	$281,550 (ie $431,550 - $150,000)
Tax payable		$208,597 (ie $508,597 - $300,000)	$150,000 (ie $431,550 - $281,550)
Breakdown of tax payable			
• Other income assessable in Australia (ie salary, investment income etc)		$58,597	$Nil
• Taxable portion of LS death benefit received		$150,000	$150,000
Other costs:			
• Medicare levy (2%)		$20,000	N/a
• Division 293 tax on concessional contributions		$3,750	N/a

Summary of tax and other costs

	William	**Harry**
Tax payable on taxable portion of LS death benefit received	$150,000	$150,000
Medicare levy (2%)	$20,000	N/a
Division 293 tax on concessional contributions	$3,750	N/a
Total "costs" imposed on taxable portion of LS death benefit received (or because of it)	$173,750	$150,000
Amount of LS death benefit "in the hand" after allowing for these costs	$826,250	$850,000

Question 2

If a lump sum death benefit of $2m (all taxable component) is paid to Charles's estate, and then 50% is then distributed to each of William and Harry, how would you calculate how much they will each receive "in the hand" (ie after Australian tax and other costs imposed on the taxable component of the LS death benefit, or because of it)?

Assume the assessable income of Charles' estate (excluding any taxable component of the lump sum death benefit) is $100,000 (from investment income). The estate has $5,000 of tax deductions.

Would William and Harry be better or worse off if Charles' death benefit was paid to his estate, and they each received the same (after tax) distribution from the estate?

Answer

The same method is used to calculate the tax payable by Charles' estate on the $2m LS death benefit it receives.

Other income assessable in Australia (ie investment income etc)		$0.10m
Taxable portion of LS death benefit received (gross)		$2.00m
Deductions		($0.005m)
Taxable income		$2.095m
Tax payable on taxable income	A	$915,847
Taxable income **excluding** taxable portion of LS death benefit received		$0.950m
Tax payable on taxable income **excluding** taxable portion of LS death benefit received	B	$22,647
Prima facie tax payable on taxable portion of LS death benefit received	A - B	$893,200
Maximum tax payable on taxable portion of LS death benefit received (15% x $2m)		$300,000
Tax offset		$593,200 (ie $893,200 - $300,000)
Tax payable		$322,647 (ie $915,847 - $593,200)
Breakdown of tax payable		
• Other income assessable in Australia (ie investment income etc)		$22,647
• Taxable portion of LS death benefit received		$300,000

The "net" LS death benefit (within the estate) will be $1.7m and William & Harry will each receive a distribution of $850,000. William will be better off by $23,750, ie equivalent to the amount of Medicare and Division 293 tax that would have been imposed on him had he received the LS death benefit directly from the SMSF. Harry will be in the same position.

Importantly, note that:

- Medicare does not apply to deceased estates,
- the tax residency status of an estate beneficiary is **not** relevant when calculating the tax payable by the estate,
- Lump sum death benefits paid to an estate from superannuation will only ever be included in the estate's income, **never** the beneficiary's own "income". This means that:
  - No other "costs" will be imposed on beneficiary, and
  - Other non-superannuation "benefits" of the beneficiary will not be affected.

Question 3

Are there any potential downsides to paying Charles' lump sum death benefit to his estate instead of directly to William and Harry?

Answer

Potentially yes.

This is because each of the States and Territories has "succession legislation" that allows certain people (ie an "eligible person") to apply to the Supreme Court for:

- provision, or
- for *further* provision

from a deceased's estate (or **"notional estate**" in the case of NSW – which can include the deceased's superannuation accounts regardless of whether a lump sum death benefit is paid to the estate upon death).

In cases where the estate is likely to be challenged, or there are beneficiaries that have not been provided for / inadequately provided for, say, in this case:

- Camilla (Charles' spouse),
- Simon (Charles' estranged son), and
- Laura (Charles' stepchild – although in NSW she would not automatically be an eligible person)

paying the lump sum death benefit to Charles' estate could cause his superannuation to be exposed to a family provision claim.

Case study 4 : Is everything going to play out as you'd planned? Some new things to consider …

Question 1

Charles' (67) ABP is currently worth around $2.5m(all taxable component). Ideally, he would have started "recycling" when he reached 60, but the SMSF had no cashflow to do so.

Charles' pension is reversionary to Camilla (62).

Camilla's own ABP had a balance of $1m at 30 June 2019.

If Charles dies unexpectedly in June 2020, how could this effect Camilla's contribution plans in the current (2019/20) and following year (ie 2020/21)?

Assume no changes had been made to Camilla's own pension, and no lump sum death benefits had been paid from Charles' ABP prior to 30 June 2020.

Answer

Camilla's total superannuation balance ("TSB") at:

- 30 June 2019 was $1m, and at
- 30 June 2020 it will be around $3.5m (she "owns" the reversionary pension balance immediately upon Charles' death).

Her non-concessional contributions caps ("NCC" cap) in 2019/20 and 2020/21 are:

- 2019/20 : $100,000, but she can trigger a 3-year bring forward (ie NCC cap is $300,000), and
- 2020/21 : $Nil as her TSB at 30 June 2020 will be more than $1.6m.

If Camilla wished to recycle, she'd need to do so in 2019/20, ie move quickly before 30 June.

The SMSF would need sufficient cash to do so, however, don't forget that Camilla could make the NCC first (from non-super money) and then withdraw an equivalent amount.

Question 2

Would your answer above be any different if Charles' pension was not reversionary (ie it ceased on his death)?

Answer

If Charles' pension **wasn't** reversionary:

- Camilla won't **own** the Charles' pension balance at 30 June 2020, unless a death benefit pension commences for her on or before that time,
- Assuming Charles' death benefit is not dealt with in 2019/20, Camilla's TSB at 30 June 2020 is likely to be well under $1.6m. This means that:

- Her non-concessional contributions cap will be $100,000 in 2020/21, and
- She is likely to be able to trigger a 3 year bring forward (and make NCC of $300k in 2020/21).

Question 3

The SMSF is sitting on a large unrealised capital gain (it holds commercial property) and a contract for sale is likely to be exchanged in July 2020 (settlement would be September 2020).

Charles and Camilla's plan had always been to sell the property while the SMSF was entirely in pension phase, so the capital gain would be **completely** exempt from tax.

If Charles' pension reverted to Camilla, and no changes were made to any account balances during 2019/20, what **method(s)** would the SMSF need to use in 2020/21 to calculate the tax exemption on its investment income?

Assume no changes are made to the current law (ie ignore the 2019/20 Federal Budget announcement that proposed to remove complexity by giving trustees a choice from 1 July 2020 to:

- Calculate the tax exemption on the SMSF's investment income in strict accordance with the tax law, or instead
- Simply use the actuarial certificate method for the entire year).

Answer

Camilla's TSB at 30 June 2020 will be around $2.5m (ie her "own" ABP of $1m, plus the reversionary pension of $2.5m).

As she has **both** a retirement phase pension and a TSB of more than $1.6m at the previous 30 June (ie 30 June 2020), the SMSF is prohibited from using the segregated method to calculate its tax exempt investment income. It must instead use the actuarial certificate method.

Question 4

If Charles' pension had <u>not</u> been reversionary to Camilla, would your answer to the previous question change? Assume no death benefit pension had commenced for Camilla prior to 30 June 2020.

Answer

Camilla's TSB at 30 June 2020 would now only be around $1m (ie her "own" ABP of $1m).

As no member would have **both** a retirement phase pension and a TSB of more than $1.6m at the previous 30 June (ie 30 June 2020), the SMSF is <u>not</u> prohibited from using the segregated method to calculate its tax exempt investment income and **must** do so at any stage when the assets are solely supporting retirement phase pensions.

This means that if all of the SMSF's assets are solely supporting pension balances at the time the property is sold (ie July 2020 when the contract is exchanged) then the capital gain will be completely exempt from tax. Remember that the tax exemption that applied to Charles' pension continues until his death benefit is dealt with (the "as soon as practicable" timing requirement was removed from the Tax Act in December 2018, with effect from 2012/13).

If Camilla rolls back her own ABP to accumulation later in 2020/21, a death benefit pension commences equivalent to the amount of "cap space" she creates, and the rest of Charles' ABP balance is cashed out as a lump

sum death benefit, the SMSF will need to obtain an actuarial certificate to claim a tax exemption on the investment income generated from that time.

The SMSF would need to use 2 methods to calculate its tax exemption in 2020/21, ie:

- Segregated method up until the time Camilla rolls her ABP back to accumulation phase, and
- Actuarial certificate method after that time, when the SMSF has a combination of retirement phase and accumulation account balances.

Bonus question

If Charles' pension was reversionary, and the actuarial certificate method had to be used for all of 2020/21, would it be a catastrophe?

Assume Camilla:

- Kept her own APB ($1m) in place up until the anniversary date of Charles' death (ie June 2021), at which time she rolled it back to accumulation, and at the same time
- Partially commuted the reversionary pension and withdrew a lump sum death benefit of whatever she could not "fit" within her transfer balance cap (say the lump sum was around $0.9m).

Answer

Depends on your definition of catastrophe! The tax exempt % is likely to be very high – in the order of 98%, which is pretty close to 100%.

When calculating the tax exempt %, the actuary would take into consideration that:

- Camilla's own balance had been in retirement phase for around 11 months, and in accumulation phase for around 1 month, and
- The reversionary pension had been in place all year (albeit a part of it - $0.9m out of $2.5m – was paid out as a lump sum death benefit in June 2021).

In this case, it may not be too painful if Charles' pension is not reversionary – and in fact, it may create contribution opportunities for Camilla that would otherwise not exist.