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SA LOCAL COMMUNITY EVENT

April 2023

Case study approaches

- Workshop considers exit strategies when a SMSF needs to take significant action to either avoid the closure of the fund or the need to dispose of assets which might have accumulated over time
- Importance of understanding the problem to find the relevant solution(s)!
- What forward planning and/or documentation might be useful?

Fund wipe out

What happens if we get to this stage?

Navigating turbulent waters

What can we do now to avoid getting to that stage in the future?

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CONSEQUENCES OF NALI

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NALI revisited

- Application of laws in 295-550 of ITAA 1997
  - Extends to income from retirement phase assets
- Operation of NALI provisions from 1 July 2018 to include non-arms length expenditure (NALE).
  - Impact of LCR 2021/2
  - Application of PCG 2020/5 - connection with the general expenses incurred (or not incurred) that taints all fund income as NALI – relief extended to 30 June 2023
  - Update of PCG 2016/5 based on LCR 2021/2

? Unresolved matters still exist

Proposed legislative amendments to be made to remedy ***general expenses*** issues within LCR 2021/2.

Other aspects of the ruling are ‘in play’ allowing us to focus on remedial actions to manage or avoid a ‘wipe out’.

Case study #1

NALI

- John & Kerry are members/directors of the Paradise SMSF
- Trustees entered into a related party LRBA to acquire commercial premises for $800,000
- The fund borrowed 100% of the purchase price from their family trust (related party lender)
- The initial terms of the written loan agreement also included
  - Interest rate – followed Div7A benchmark requirements (per income year)
  - Loan term of 25 years, secured by registered mortgage

Question 1

What do we need to consider (if anything) with the NALI provisions in respect to this LRBA loan facility if the property acquisition occurred in say the 2014-15 vs. 2019-20 income years?

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Case study #1

If property acquired in say 2014-15?

- Arrangement was initially deemed arms-length for SIS purposes (terms more favourable to the SMSF)
- ATO changed view on application of NALI provisions – introduced PCG 2016/5 and required compliance with the safe harbour by 31 January 2017

Amended terms to comply

- Safe harbour terms met (or externally supported as arms-length)
- NALI provisions will not permanently taint the ordinary and statutory income of the property

Terms not amended

- Safe harbour terms met (or externally supported as arms-length)
- NALI provisions will not permanently taint the ordinary and statutory income of the property

Reference: https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/SMSF-resources/SMSF-technical/PCG-2016/5-frequently-asked-questions/

Case study #1

If property acquired in say 2019-20?

- Any related party arrangement entered into must be established and maintained either:
    - In accordance with PCG 2016/5; or
    - Externally supported arrangement that demonstrates an arms-length dealing (e.g. documented bank offer)

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Case study #1

If property acquired in say 2019-20? cont.

- Impact of LCR 2021/2 ?
  - Scheme involves SMSF entering into LRBA with family trust, complying with terms of LRBA, purchasing the property, and deriving rental income
  - LRBA terms constitute a non-arms length dealing - SMSF incurring expenditure in gaining or producing rental income that was **less** than would otherwise be expected **if** those parties were dealing with each other at arm's length.
  - Rental income for **all** income years is NALI, regardless of whether the LRBA is subsequently refinanced on arm's length terms.
  - Capital gain event also treated as NALI, regardless of whether the LRBA is subsequently refinanced on arm's length terms.

Case study #1

Division 7A & LRBA Safe Harbour

- How do John & Kerry deal with the conflicting conditions within the ATO published guidance?
    - **Div.7A complying loan** – written agreement, minimum interest rate, maximum loan term (up to 25 years)
        - RBA rate – bank variable house loans; interest rate 2022-23 = 4.77%
    - **PCG 2016/5** – Safe harbour for real property
        - RBA rate – bank standard variable housing loan for investors; interest rate 2022-23 = 5.35%

Question 2

What do we need to consider with the LRBA to comply with both the PCG 2016/5 and Div.7A requirements?

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Real Property – safe harbour

Item	Treatment
Interest rate	Benchmarked against the Reserve Bank of Australian Indicator Lending Rates for banks providing standard variable housing loans for investors. Refers to the rate published for the month of May immediately prior to the start of the relevant financial year.
Fixed or variable	Variable uses the above rates each year. Fixed uses the above rate at inception, but can only fix for a maximum of 5 years, then reverts to variable.
Term of the loan	Maximum of 15 year term. If re-financing the maximum re-financed term cannot exceed 15 years less the duration of any previous loans.
LVR	Maximum 70% LVR.
Security	Requires a registered mortgage over the property.
Personal guarantee	Not required
Nature and frequency of repayments	Payments must comprise principal and interest. Monthly repayments.
Loan agreement	Written and executed loan agreement is required.

Case study #1

Division 7A & LRBA Safe Harbour

- Where requirements of section 109N of ITAA 1936 are satisfied, will need to measure the loan against each of the following requirements:

Interest rate

- Need to analyse each year between both ATO guidance – i.e. Div.7A, requires the interest rate on the loan ≥ to benchmark interest rate (for each year).
- Safe harbour rate in PCG 2016/5 set higher currently at 5.35% (compared to 4.77%), so expectation would be to adjust in line with the standard variable rate - housing loans for investors.

Loan term

- Compliance with LRBA safe harbour as maximum allowable loan term is 15 years – Div.7A laws allow for up to 25 years.
- Both legislation imposes the loan to be secured by a mortgage over the real property (beyond 7 years).

LVR

- The SMSF rules impose much tighter LVR terms - maximum LVR of 70% applies for real property.
- For Div.7A, rules allow for the market value of the property to be 110% of the amount of the loan.

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Case study #1

What do we do if the property is permanently tainted with NALI?

- Let's assume that John & Kerry did not refinance the LRBA to comply with the safe harbour?
- NALI provisions now permanently taint the income and capital of the property!

Question 3

What options are available to John & Kerry in respect to the commercial property now that the arrangement is subject to NALI?

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Case study #1

What do we do if the property is permanently tainted with NALI?

1. **Remediate and seek ATO discretion to waive NALI assessment?**

- Least expensive option (if successful)
- Commitment to compliance with safe harbour – adjustments to investment strategy (e.g. access to sufficient cash flow and/or liquid assets to meet revised loan repayments)
- Voluntary disclosure / early engagement most likely action for any success (although not guaranteed)

Case study #1

What do we do if the property is permanently tainted with NALI?

2. **Retain the asset in the SMSF, even after ATO declines waive of NALI assessment**

- Arguably the least attractive option!
- NALI tax rate applies, even when in retirement phase
- Being able to maximising deductions against the specific asset would be a key strategy as NALI tax rate (45%) applies to 'net income' (after deductions)
- CGT impact likely to be significant – tainted from acquisition. Where pre-2014-15, no recognition for unrealised position in prior years where fund did not comply with PCG 2016/5 (permanently tainted).
- May be only viable option where unable to remediate, transfer or dispose of the asset

Case study #1

What do we do if the property is permanently tainted with NALI?

3. Dispose of the asset and pay out the loan?

- Given significant future tax impost on ordinary and statutory income, does the trustee 'cut its losses'?
- Opportunity to restructure asset – retained within the family 'group'?
  - Would need to address the existing loan as part of sale process
- Where BRP, could asset be transferred to another SMSF – 'phoenix' arrangement (satisfies SIS laws)
  - E.g. market value, related party acquisition rules, etc.
  - Establish a new related party loan to assist in acquisition by new SMSF
    - Requires sufficient liquidity to support the purchase (sell-down other assets?)

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Case study #1

What do we do if the property is permanently tainted with NALI?

Other considerations

- Where new SMSF takes over the asset (starts afresh), expect increased scrutiny on successor fund to ensure arms-length dealings were established and continued
- Term of related party loan in new SMSF?
  - How long had the RP loan been in existence in the old SMSF?
  - What if fixed interest period (5 years) has already been utilised?
  - Conservative approach – do you ensure that new loan term is 'compatible' to the loan in the old fund? E.g. loan term is based on remaining term from original SMSF loan? Variable interest rate only (if fixed previous used)

Case study #1

What do we do if the property is permanently tainted with NALI?

Other considerations cont.

- Stamp duty considerations?
    - Need to understand different approaches to stamp duty – exemptions (e.g. SA), concessional duty or full ad-valorem duty?

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Case study #1

How to avoid failure against safe harbour

- Trustee has full control of issue
- Play an active role in helping to continually comply with safe harbour
    - e.g. repayment adjustments due to interest rate changes
- Document these decisions where changes are made

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UNPAID PRESENT ENTITLEMENTS

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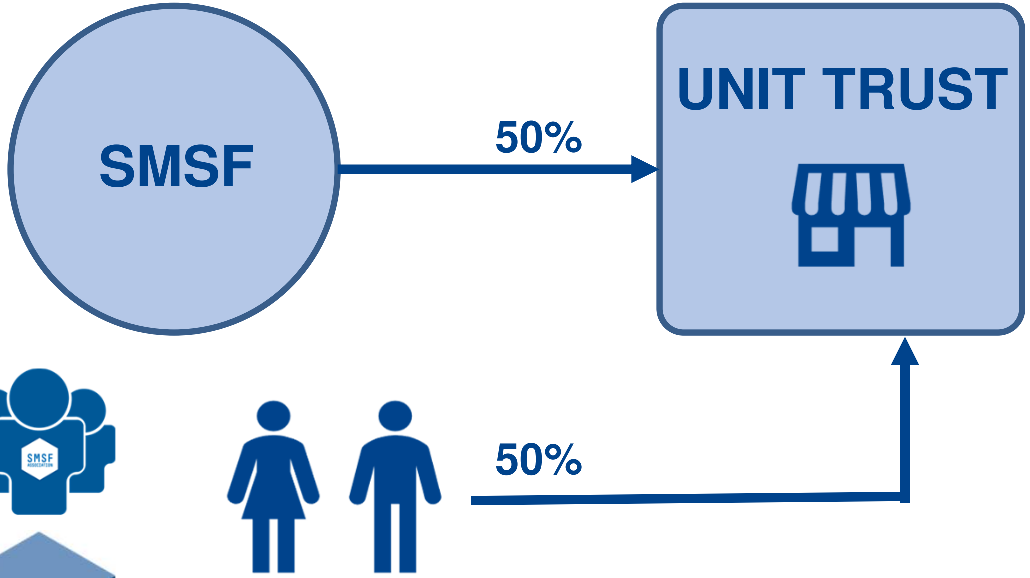
Case study #2

Consequences of UPE



- Greg & Debbie are members/directors of an SMSF
- Invests jointly in a SISR 13.22C unit trust to hold BRP in which they operate their business
- Trust has multiple years of unpaid distributions ($150k) and no amounts reinvested into new units
- No specific date has been indicated by SMSF to seek payment (will occur at a later time), nor any amounts set aside in the trust for distribution payments (unable to currently pay).

Case study #2

Consequences of UPE

Conclusion:

- With no specific loan agreement or definite date for payment - provision for financial accommodation by the SMSF to the Unit Trust due to:
  - The two trusts are controlled by Greg & Debbie
  - The amounts of the distributions deferred are substantial; and
  - The timeframe of the deferral is large and a pattern of deferring payment has been established now of a number of years.

Consequence

The $150,000 amount in unpaid distributions are considered to be **loans** under the extended definition, being from SMSF to trustee of Unit Trust – provision of financial accommodation (see 109D(3) of ITAA 1936)

Case study #2

Consequences of UPE

- Triggers subregulation 13.22D(1)(c)(i)

  "If regulation ….13.22C applies to an asset, that regulation ceases to apply to the asset if any of the following events happens:

  (c) the company, or a trustee of the unit trust:

  (i) borrows money…."

- 'Fatal' outcome permanently tainting the arrangement, removing the IHA exception
- IHA likely to be above 5% of MV of fund assets; action required via a written plan (section 82, SIS Act).

Case study #2

Consequences of UPE

Case study questions:

1. What steps must the trustee undertake within the written plan to bring the IHAs to below the 5% threshold?
2. What options does the fund trustee have to facilitate a disposal of the asset to comply with the IHA rules?
3. What needs to be considered by the trustee as part of the disposal options in (2)?

Case study #2

In-house asset breach

Holding one asset

- If the SMSF is only hold one IHA, it will be required to dispose of that asset – no provision for partial disposals to bring under 5% threshold
- Holding would need to be divested by no later than the end of the financial year following the UPE outcome
- **Ultimately, creates a ‘fatal’ outcome within the 13.22C arrangement to retaining the units in the SMSF.**

The written plan must:

- specify the amount (excess amount) – using IHA formula, s.82(3) of SIS Act
- set out the steps which the trustee proposes… to take in order to ensure that:
  a) one or more of the fund's in-house assets held at the end of that year of income are disposed of during the next following year of income; and
  b) the value of the assets so disposed of is equal to or more than the excess amount.
- be prepared before the end of the next following year of income.

Case study #2

In-house asset breach

Alternative ownership structures:

- Sale to the SMSF from the unit trust? SIS, income tax & stamp duty consideration
  - Tenants in common, full ownership (including use of LRBA)?
- Exit the SMSFs involvement altogether?

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LARGE RESERVES

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Case study #3.1

Large reserves

Facts:

- Cece Lugg (CL) and Sammi Seel (SS) are ABP members of Nor Tickle SMSF (NT SMSF)
  - CL and SS are nominated auto-reversioners for each other's ABP
  - CL (aged 80) has ABP balance of $300,000
  - SS (aged 81) has ABP balance of $400,000
  - Reserves of $290,000
  - SS dies in the 2022/2023 financial year

What do we do ?

What happens if we do nothing ?
What action can be taken to avoid adverse outcome in future ?
What do we need to confirm first ?

Case study #3.1

Large reserves

What do we need to confirm first ?

- Trust deed and any fund rules about reserve allocation:
  - general allocation rules,
  - members on death,
  - limitations
- Previous year allocations which triggered CC assessment
- TSB at start of year < $500,000 – other super ?
- Personal income tax position of members
- Centrelink issues
- Other potential members

Reserve issues

What do we need to understand or research ?

- Trust deed clauses relating to reserves, wind up and “rights” of former members
- Consequences of reserve allocations
- How far can you go ?

Reserve allocations

ITAR 291.25.01

Reserve allocation is assessed against concessional cap if it does not satisfy tests:

a) *the amount is allocated, in a fair and reasonable manner:*
   i. *to an account for every member of the complying superannuation plan; or*
   ii. *if the member is a member of a class of members of the complying superannuation plan, and the amount in the reserve relates only to that class of members - to an account for every member of the class; and*

b) *the amount that is allocated for the financial year is less than 5% of the value of the member's interest in the complying superannuation plan at the time of allocation; and*

c) *the amount would not be assessable income of the complying superannuation plan if it were made as a contribution.*

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Unused concessional contributions cap

Commenced 1 July 2018

Year	Standard Concessional Cap	2022/2023 Unused Concessional Cap	2023/2024 Unused Concessional Cap	2024/2025 Unused Concessional Cap
2018/2019	$25,000	$25,000	$25,000	
2019/2020	$25,000	$25,000	$25,000	$25,000
2020/2021	$25,000	$25,000	$25,000	$25,000
2021/2022	$27,500	$27,500	$27,500	$27,500
2022/2023	$27,500	$102,500	$27,500	$27,500
2023/2024	$27,500		$130,000	$27,500
2024/2025	$27,500			$132,500

Treatment of excess concessional contributions

ITAR 291.25.01

- If a person has an excess concessional contribution in a specific year, then:
    - the excess amount is included in their personal assessable income for the year, and
    - a tax offset is applied, being 15% of the excess concessional contribution.
- The tax offset is only available to be applied against any tax payable, it cannot be carried forward or refunded.

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Case study #3.1

Large reserves – do nothing

Outcome:

- CL balance becomes $700,000
- TSB > $500,000 for next (2024) financial year
- Restriction on reserve allocation
- Allocate $27,500 to avoid excess CC
- Allocate $76,380 ($27,500 + $48,880) to trigger excess CC but pay no tax
- Reserves of $213,620 remain to be treated in future

Consequence

Problem is smaller, but it remains if member dies

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Case study #3.1

Large reserves – take action:

- Allocate reserves to CL (addition to account) and SS (death benefit payment)
- Can we allocate (gets bigger as we go on):
  - 5% = $35,000 ($15,000 + $20,000), or
  - Maximum unused CC cap = $205,000 ($102,500 + $102,500), or
  - Maximum unused CC cap plus current year CC = $260,000 ($130,000 + $130,000), or
  - Trigger excess CC to absorb full $300,000 ($150,000 each)

Limitations

Other taxable income
Can trigger NCC assessment, avoid excess NCC ($110,000 above 75)
Can we absorb the full reserve or is there still a residual

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Case study #3.2

Residual reserves after complying pension completes

Facts:

- Perry Winkle (PW) is sole member of Quatic Fund (Q Fund)
  - Complying term pension has just completed with leftover funds of $300,000
  - PW (aged 82) also has ABP balance of $15,000

Potential problem

Even with optimised maximum allocation of $178,880 we are left with large reserve.

What are our options ?

Case study #3.2

Residual reserves after complying pension completes – take action

Option 1 – allocate all to PW:

- Take excess CC to $110,000 (also counts against NCC cap)
- This absorbs $240,000 ($130,000 maximum possible non-excessive plus excessive CC of $110,000)
- Taxable income = $110,000 gives tax of $28,417 less $16,500 (15% offset), $11,917
- Allocate balance of reserves next year (tax effective cap is $76,380)

Small cost to solve the problem ?

This results in member retaining maximum balance in their name
Are there more tax effective options ?

Case study #3.2

Residual reserves after complying pension completes – take action

Option 2 – introduce other members:

- Take excess CC to $110,000 (also counts against NCC cap)
- Short term additions to help absorb reserves
- Capacity may be limited – depends on:
  - CC history
  - Personal tax position
  - Preservation restrictions
  - Desire to distribute to other family members

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Case study #3.3

Residual reserves after death of a lifetime pensioner

Facts:

- Marlon (M) is sole member of Beech Bun SMSF (BBSF), no surviving spouse
  - Lifetime pension completes on M's death
  - Remaining balance of $300,000
  - No other members or accounts
  - What can we do ?

Potential problem

Does the SMSF have any members ?
Does the SMSF wind up ?

Case study #3.3

Read the deed

What we are looking for:

- Trustee succession
- Member addition
- Wind up requirements
- Reserve allocation rules or opportunities – former members ?

Review the Trust Deed

What can be done ?
What can't be done ?
Review your deed now, don't wait for this to happen

Planning before the event

- Common theme underlying each of these potential ‘wipe out’ outcomes is that trustees need to be prepared in advance on what to look out for (risk management).
- Finding the issue early can help, but may not be enough to ‘save’ from a SIS compliance standpoint.
- Where relevant, suggested path would be early engagement / voluntary disclosure with the Regulator.
- Importance of playing an active and ongoing role through each financial year with clients – rules do operate very differently to personal and non-SMSF entities (e.g. family trusts)!

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STRATEGIES

Questions