Technical Summit 2022

DEEP DIVE 5

Exit strategies - Can you avoid a wipe out?

Speaker
Aaron Dunn
Title
CEO
Organisation
Smarter SMSF

Speaker
Peter Crump
Title
Senior Consultant
Organisation
BDO Adelaide

Exit strategies - Can you avoid a wipe out?

1. Overview

This paper supports a workshop which considers the exit strategies when a self-managed superannuation fund (SMSF) needs to take significant action to either avoid the closure of the fund or the need to dispose of assets which might have been accumulated over time.

We will consider:

- what happens if we get to that stage?
- what can we do now to avoid getting to that stage in the future?

The workshop uses a number of case studies which are included in a separate Power Point presentation, including a discussion of the key concepts that are relevant.

Within each case study we have included consideration as to what forward planning or existing documentation might be useful to assist in mitigating the cost of any "wipe out" event. By understanding the problem we can better understand the solution.

2. Consequences of non arm's length income (NALI)

NALI revisited

The taxable income of a superannuation fund has two components:

- a low tax component, taxed at 15% (or nil if exempt income applies under retirement income streams), and
- a non-arm's length component, which is taxed at the top marginal tax rate.

Importantly, any non-arm's length income (NALI) is unable to be treated as exempt income, even if the fund would otherwise be eligible to do so with the income supporting retirement income streams.

Fortunately the ATO has confirmed[1] that they will "*not allocate compliance resources to determine whether the NALI provisions apply to a complying superannuation fund for the 2018-19, 2019-20, 2020-21, 2021-22 and 2022-23 income years where the fund incurred non-arm's length expenditure …*", and this only applies to general expenditure that is incurred on or before 30 June 2023.

This issue is still under significant strain as questions are raised about the application, intent and outcome of the provisions relating to NALI and non-arm's length expenditure (NALE). This paper is presented on the basis that the provisions will be implemented in the future as stated, since the focus is to illustrate remedial actions to avoid or manage a "wipe out" event. It is not in the scope of this paper to debate the appropriateness of the provisions.

---

[1] ATO: Practical Compliance Guidelines PCG 2020/5 - Applying the non-arm's length income provisions to 'non arm's length expenditure' - ATO compliance approach for complying superannuation entities, last updated 10 June 2022

Safe harbour provisions

PCG 2016/5[2] presents the ATO's interpretation and approach in considering how NALI can arise under a Limited Recourse Borrowing Arrangement (LRBA) involving a related party lender. The Guidelines set out the so called "Safe Harbour" terms which trustees of SMSFs can follow to ensure that they will be considered to be engaging in arm's length dealings where the borrowing is from a related party. The guidelines state (paragraph 4):

"*The trustees will need to be able to otherwise demonstrate that the arrangement was* *entered into* *and* *maintained* *on terms consistent with an arm's length dealing*" (author's emphasis added). This makes it clear that it is not just an establishment requirement but also an ongoing requirement to satisfy the arm's length tests.

In general terms, where the asset is real property the Safe Harbour terms address:

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.
Loan to Market Valuation Ratio (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.

[2] ATO: Practical Compliance Guidelines PCG 2016/5 - Income tax - arm's length terms for Limited Recourse Borrowing Arrangements established by self-managed superannuation funds, last updated 21 March 2022

The ATO made specific mention in its *COVID-19 – frequently asked questions*[3] that the loan repayment terms could be temporarily adjusted as a result of COVID-19 to mirror the concessions which were afforded parties dealing on an arm's length basis, such as applied from commercial lenders.

These repayment relief provisions allowed for interest being deferred and capitalised for a suggested period of up to 6 months and then repaid.

Additional provisions allowed for rental payments to be reduced because of the financial effects of COVID-19, even for related parties.

In both of these cases, it was noted as being important that the variation to the standard loan or rental agreement should be documented and should be consistent with the relief provisions which would apply to arm's length parties under the same circumstances.

Related party loans and Division 7A

It is not uncommon to see funds entering into limited recourse borrowing arrangements with related party entities – for example, a family trust. In this situation, it is important that consideration is not only given to the safe harbour provisions of PCG 2016/5, but also whether the loan falls within the Division 7A requirements of the ITAA 1936?

The Division 7A laws contemplate whether the amount would be deemed as a payment of dividends, rather than as a complying loan. Section 109N of the ITAA 1936 sets out the criteria for such an amount to be classified as a loan and be explicitly exempted from being deemed as a dividend, which includes:

- the loan being made under a written agreement
- the loan having a minimum interest rate
  - the ATO publishes benchmark interest rate each year, based upon the *'Indicator Lending Rates – Bank providing variable housing loans interest rate'* – (2022-23 rate is 4.77%)
- the loan has a maximum loan term

For a related party LRBA complying with the ATO safe harbour in PCG 2016/5, this benchmark interest rate applies a different RBA indicator rate, being the *'Indicator Lending Rates for banks providing standard variable housing loans for investors'* – for 2022-23, this rate is 5.35%.

So how do we comply with both of these requirements?

Where the requirements of Section 109N are satisfied, we need to measure the loan against each of the requirements:

---

[3] ATO: COVID-19 - frequently asked questions - Self-managed super funds (answers updated between March 2020 and May 2020) - [COVID-19 FAQ | Legal database (ato.gov.au)](), accessed 10 July 2022

- **Interest rate** – we are required to analyse this for each year between both pieces of ATO guidance – that is, for the purposes of Division 7A, this requires the interest rate on the loan to be greater than or equal to the benchmark interest rate (for each year). Therefore, with the safe harbour rate in PCG 2016/5 set higher currently at 5.35% (compared to 4.77%), the expectation would be to adjust in line with the standard variable rate - housing loans for investors.
- **Loan term** – compliance would be required with the LRBA safe harbour, given that the maximum allowable loan term is 15 years – the Division 7A laws allow for up to 25 years. Both pieces of legislation imposed the loan to be secured by a mortgage over the real property.
- **Loan to Value Ratio (LVR)** – the LRBA Safe Harbour rules impose much tighter LVR terms, whereby a maximum LVR of 70% applies for real property, whereas the Division 7A rules allow for the market value of the property to be 110% of the amount of the loan.

As can be seen, the current Safe Harbour guidelines appear more restrictive than the current Division 7A rules (i.e. higher interest rate, shorter maximum term, lower maximum LVR and a registered mortgage – regardless of loan term). For this reason, it is recommended that an SMSF follows the Safe Harbour Guidelines to ensure the loan satisfies both criteria.

If the trustee(s) decided not to follow the Safe Harbour Guidelines, they will need to be able to demonstrate otherwise that the loan is on arm's length terms (i.e. benchmarked to commercial LRBA). However, they must also continue to give consideration to the requirements of a complying loan for Division 7A purposes where those are more restrictive.

Failing the safe harbour provisions

As discussed above, the paper and workshop are intended to illustrate the outcome and potential remedial actions to adverse events and not to consider the merits or otherwise of the policy that is being breached in that case study.

A persistent failure to follow the Safe Harbour terms for a non-arm's length LRBA can result in the income from the property being assessed as NALI. What are the potential options in those circumstances?

1. Remediate and seek ATO discretion to waive NALI assessment

This is likely to be the least expensive option for the trustee, to determine the areas that must comply with the Safe Harbour – e.g. if underpayment of interest and to seek to remedy that, the trustee will need to make sure that future interest payments are consistent with Safe Harbour provisions. It will, however, impose a financial discipline on them that the trustee needs to have access to sufficient cash or liquid assets to meet the catch up and continue with the appropriate loan repayments.

Prudent behaviours would suggest that making the remediation and advising the ATO is likely to be better received as a problem solved than to ask if that action will achieve a favourable outcome from the ATO, being a problem with a solution yet to be adopted.

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

This is the least attractive option as future income will be taxed at the highest marginal rate. Maximising deductions against the specific asset's income will be a key strategy as it is the net income (after deductions) which is taxed at the top marginal rate.

The greatest potential pain will come when the asset is sold as any realised gain will be taxed at the top marginal rate. Since gains are only realised when an asset is sold, there is no recognition or credit for the unrealised gain which accrued up to the time of the NALI event or NALI assessment. This can result in a significant overnight change in the future tax provision if there are unrealised gains on foot.

As discussed above, this applies even if the fund would otherwise be exempt from tax on its investment income as a result of the fund fully supporting retirement income streams.

While this is the least attractive option, it might be the only viable option if it is not possible to remediate the interest shortfall or to sell the asset from the fund. This will result in all future years of income from the asset and the growing capital gains when realised being taxed at the top marginal rate.

3. Dispose of the asset and pay out the loan

Facing the likelihood of significant future tax impost and a potentially growing unrealised gain which will be realised in the future, the trustee might prefer to "cut its losses" and arrange for the disposal of the asset and repayment of the loan.

The asset could be sold to a related entity, for market value, so that the ownership of the asset was retained in the overall "family". This would require the loan to be addressed as part of that process.

If the asset was a commercial property, meeting the definition of Business Real Property[4], a new SMSF could be used to establish a type of "phoenix" arrangement, but in a legitimate manner. The asset could be transferred to the new fund and market value consideration would need to be paid to the former fund for the property.

While a new related party loan could be initiated in the new SMSF to assist in the purchase the property, there would need to be sufficient liquid funds in the new SMSF to support the take on of the property, and this is likely to require the liquidation of other assets in the SMSF to assist with that.

---

[4] ATO SMSFR 2009/1 Self-Managed Superannuation Funds: business real property for the purposes of the Superannuation Industry Supervision Act 1993 provides a detailed discussion on what constitutes business real property

What are some of the considerations that need to be made here?

There does not appear to be any issue with the new SMSF taking on the asset which had been tainted with NALI in the former fund and effectively starting afresh. It is likely that the ATO would keep a close watch on the successor SMSF to ensure that arm's-length dealings were implemented and continued.

Special consideration needs to be given to the terms of the related party loan in the new SMSF. Should it restart as a new loan for the maximum term of 15 years and have a fixed interest rate period of up to 5 years, even if the loan under the former fund had been on foot for some time and had already used the 5-year fixed period? A conservative approach would be to ensure that the terms of the loan were compatible with the terms that would have applied if the loan had been in place under the former fund, so that:

- the remaining term of the loan was no longer than 15 years from the commencement of the original SMSF loan, and
- interest was determined on a variable basis.

The issue of stamp duty and other transfer costs cannot be ignored. The different states and territories have different approaches to stamp duty on such transactions – from an exemption for such transactions, to concessional duty being applied, through to full ad-valorem duty (e.g. South Australian transfers of commercial property are not subject to stamp duty).

How to avoid a failure against the Safe Harbour provisions

The trustee is in full control of this issue. Ultimately it comes down to education and understanding. It is important that we educate our clients about the importance of the Safe Harbour provisions and the need to meet them at all times.

Our clients need to be reminded that dealings between related parties need to satisfy the regulator's requirements at all times and it is better to stay at the centre of "reasonable" dealings rather than push the boundaries.

Perhaps it is no different to the issues which advisers need to raise with a potential new SMSF participant that they need to fully understand the rules and be reminded of them on a regular basis.

Mitigation is another strategy to follow if we find that a client has not satisfied the Safe Harbour provisions, identify it and fix it and advise the regulator are possibly the best actions in the event of a minor swell ahead of what could be a wipe out wave.

3. Unpaid present entitlements

Related party trusts (other than pre-1999 trusts)

A fund can only hold "in-house assets" where the market value of those in-house assets is less than 5% of the total assets of the fund by market value[5], without triggering remedial action involving the sale of some or all of the in-house assets.

For this purpose an in-house asset is defined[6] as "*a loan to, or an investment in, a related party of the fund, an investment in a related trust of the fund …*" (abbreviated for the purpose of context), subject to a number of exceptions. One of the exceptions is specified[7] as being:

> "*an investment in a company or unit trust [which] was acquired by the fund …and is not affected by subregulation 13.22D(3)*";

To be treated under this exception, certain conditions need to be met by an SMSF, including (abbreviated for context):

- the company, or a trustee of the unit trust, does not have outstanding borrowings; and
- the assets of the company or unit trust do not include:

  "a loan to another entity, unless the loan is a deposit with an authorised deposit-taking institution within the meaning of the Banking Act 1959; or

  an asset over, or in relation to, which there is a charge; or

  an asset that was acquired from a related party of the superannuation fund after 11 August 1999, unless the asset was business real property acquired at market value; or

  an asset that had been at any time (unless it was business real property acquired by the company, or a trustee of the unit trust, at market value) an asset of a related party of the superannuation fund since …. the day 3 years before the day on which the fund first acquired an interest in the company or unit trust."

Sub regulation 13.22D confirms that the privileges and concessions in Regulation 13.22C cease to apply if (inter alia) the assets of the company or unit trust include a loan or charge over an asset.

The provisions of Regulation 13.22C have allowed SMSFs to invest in what would otherwise be related party unit trusts the assets of which include commercial property that is leased to a related party. This has allowed partial ownership of commercial property within a SMSF structure alongside ownership by other related individual and/or entities. In most cases the holding in the unit trust would be well above 5% of the value of the assets of the fund and would not be able to be retained if it was an in-house asset.

---

[5] *Superannuation Industry (Supervision) Act 1993* (SISA) – Section 82

[6] Ibid – Section 71

[7] *Superannuation Industry (Supervision) Regulations 1994* (SISR) – Regulation 13.22C

Unpaid present entitlements revisited

The ATO confirms[8] that an unpaid present entitlement (UPE) arises "*where a private company beneficiary is made presently entitled to trust income and that entitlement is not satisfied*", and also states:

"*A private company beneficiary with a UPE, by arrangement, understanding or acquiescence, consents to the trustee retaining that amount to continue using it for trust purposes if the company has knowledge of an amount that it can demand immediate payment of from the trustee, and does not demand payment.*

*This constitutes the provision of financial accommodation to the trustee under paragraph [*Income Tax Assessment Act 1936*] 109D(3)(b). As a result, the private company beneficiary makes a loan to the trustee under the extended definition of a 'loan' in subsection 109D(3).*"

These comments are instructive when considering the consequences of an unpaid present entitlement in a 13.22C unit trust.

Consequence of UPE – in-house asset

If there is an entitlement to a distribution to any beneficiary that remains unpaid this will be regarded as a loan or financial accommodation to that party. It does not matter whether the party with the UPE is the SMSF or other unit holders, there is still a loan in place.

This then triggers SISR Regulation 13.22D, namely sub-regulation (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 ….*"

In effect, the UPE is a loan or accommodation from the beneficiary to the unit trust and if this is regarded as having occurred, unless resolved this a fatal outcome for the SMSF's holdings in the unit trust. At the time of the determination that the UPE exists the holdings in the related party unit trust are treated as an in-house asset. If, as is most likely, the in-house assets would represent more than 5% of the market value of the fund assets at the end of the relevant financial year, action must be taken[9]:

> "*… the trustees of the fund, must prepare a written plan.*
>
> *(3) The plan must specify the amount (the excess amount) worked out using the formula* [which determines the excess of the in-house assets over the 5% threshold]
>
> *(4) The plan must set out the steps which the trustee proposes …..to take in order to ensure that:*

---

[8] ATO TD 2022/11 "Income tax: Division 7A: when will an unpaid present entitlement or amount held on sub-trust become the provision of 'financial accommodation'?" – paragraphs 7 to 9

[9] *Superannuation Industry (Supervision) Act 1993* (SISA) – Section 82

> *(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.*
>
> *(5) The plan must be prepared before the end of the next following year of income."*

If the SMSF is only holding one in-house asset, it will be required to dispose of that asset, as there is no provision for partial disposals to bring the in-house assets below the 5% threshold.

Allowing a UPE in a Regulation 13.22C related party unit trust would therefore seem to be fatal to retaining those units in the SMSF.

The holding would therefore need to be divested by no later than the end of the financial year following the UPE outcome.

Alternative ownership structures then need to be considered to allow the re-engagement in the financial involvement. Potentially some form of tenants in common arrangement (or even full ownership if there is capacity) where the underlying commercial property was partially sold to the SMSF from the unit trust, but this would have tax and stamp duty considerations within the trust itself.

How to avoid a failure against the UPE provisions

If there is insufficient capacity to make the distribution to unit holders, the distribution could be used to purchase new units in the unit trust[10]. Of course this needs to be properly documented to evidence the creation of new units in exchange for the distribution that would otherwise have been paid to the SMSF.

The trustee is in full control of this issue. Ultimately it comes down to education and understanding. It is important that we educate our clients about the importance of ensuring that distributions are paid in full each year or appropriate alternative actions are addressed ahead of the end of the financial year if that is not possible for some reason.

Our clients need to be reminded that dealings between related parties need to satisfy the regulator's requirements at all times and it is better to stay at the centre of "reasonable" dealings rather than push the boundaries.

---

[10] ATO SMSFR 2009/3 – "Self Managed Superannuation Funds: application of the Superannuation Industry (Supervision) Act 1993 to unpaid trust distributions payable to a Self Managed Superannuation Fund" - Example 4

4. Residual reserves

The existence of reserves in SMSFs has been subject to some creative and conjectural discussion in the past but the ATO[11] presented a clear view that it expected that there would be limited circumstances under which a SMSF would maintain a reserve and "*only for specific and legitimate purposes*". Having said that, a line as drawn as at 1 July 2017 so that the ATO "*will not apply compliance resources to review arrangements entered into by SMSFs as described in this Bulletin before 1 July 2017 provided that:*

a. the reserve was permitted by section 115 of the SISA and the governing rules of the SMSF, and
b. *the facts and circumstances do not indicate that the use of the reserve by the trustee was a means of circumventing the restrictions imposed by the Government's Superannuation Reform measures announced in the 2016-17 Budget.*"

Section 115 of SISA permit a trustee to maintain a reserve "*for a particular purpose, unless the governing rules … prohibit the maintenance of a reserve for that purpose*".

In general terms the reserves that we are likely to come across which meet these requirements are:

- reserves which were created as "investment smoothing" reserves prior to 1 July 2017 and which still remain, and
- reserves arising from complying or defined pensions where the pension term has completed and assets have yet to be fully expended in the support of that pension.

These very different circumstances need to be considered separately.

The latter is currently topical as we are seeing term pensions which commenced in the early 2000s now reaching their originally nominated payment terms and funds which were targeted to support that pension remain behind. Similar outcome occurs with a lifetime pension where the final lifetime pensioner or reversioner dies and leaves unspent capital.

This paper is presented on the basis that the residual balance remaining on completion of the pension (i.e. completion of nominated payment term or death of the lifetime pensioner) remains as a reserve for the purpose of illustration. It is not in the scope of this paper to debate the merits of this against other properly placed arguments.

[11] SMSFRB 2018/1 – "The use of reserves by self-managed superannuation funds"

Reserve allocations revisited

Concessional contributions are quantified under ITAA Section 291.25[12] as including an amount "*if it is allocated by the superannuation provider in relation to the plan for you for the year in accordance with conditions specified in the regulations*".

So called reserve allocations are addressed under ITAR Regulation 291.25.01, which specifies[13] conditions which need to be met to avoid the allocation being assessed against the concessional contributions cap:

(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.

A reserve allocation which does not meet these exceptions is counted as a concessional contribution and is assessed against the person's concessional contributions cap to determine whether an excess has occurred.

In most cases, allocations are likely to be either:

- greater than 5% of the respective members' account balances, or
- not allocated in a consist ("fair and reasonable") manner to every member of the fund or segment of the fund.

Concessional contributions cap revisited

Historically (at least up until 1 July 2019), we have regarded a person's concessional contributions limit as being the "concessional contributions cap", being the one-year contribution amount of $27,500 (current 2023 financial year).

For persons with a Total Superannuation Balance less than $500,000 at the preceding 30 June, an additional amount is added to the cap, being the "unused concessional contributions cap"[14], which is the aggregate additional amount of concessional contributions which could have been made in the previous 5 financial years without exceeding the concessional contributions cap in each of those years.

[12] *Income Tax Assessment Act 1997* Section 291.25
[13] *Income Tax Assessment (1997 Act) Regulation 2021* – Regulation 291.25.01 sub reg (4)
[14] *Income Tax Assessment Act 1997* Section 291.20

The provisions only started with effect from 1 July 2018, which means that the maximum concessional contribution which might be made for a person, assuming they had no history of concessional contributions, would be:

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

Allowing for the concessional contributions cap in the current year, an eligible person (TSB less than $500,000, no previous year concessional contributions) has capacity for total concessional contributions without creating an excess of:

Year	One Year Concessional Cap	Maximum Unused Concessional Cap	Total Concessional Cap
2022/2023	$27,500	$102,500	$130,000
2023/2024*	$27,500	$130,000	$157,500
2024/2025*	$27,500	$132,500	$160,000

* Assumes no cap indexation at 1 July 2023 or 1 July 2024.

This provides significant scope for one-off reserve allocations to be made for a member who, by virtue of age, may not have been able to make concessional contributions but who can still have reserves allocated and for these allocations to be assessed against their respective cap. There are two unrelated issues at play here:

- the ability to make a contribution, and
- the capacity to have a concessional contributions cap which is available for reserve allocations.

Excess concessional contributions revisited

If a person has an excess concessional contribution in a specific year, then[15]:

- 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.

If the person has no other assessable income, they would have capacity for an excess concessional contribution amount without incurring tax. What is that capacity?

An additional $48,880 of excess concessional can be carried without incurring personal tax (for simplicity any senior tax offsets are ignored):

- tax on $48,800 is $6,353,
- Medicare levy at 2% is $978, and
- 15% offset is $7,332.

This means that in the current financial year a person who has no taxable income and no history of concessional contributions has the capacity to receive reserve allocations of up to $178,880 without a tax consequence (potentially further with any eligibility for seniors and pensions tax offset).

This could prove useful in clearing reserves remaining after a pension has completed and a residual reserve remains.

If a fund member has a TSB in excess of the $500,000 this will limit the ability to use of the catch-up concessional contribution rules. Alternatively, through the reversion (or purchase) of death benefit income streams, the TSB of the tax dependant beneficiary (i.e. spouse) will increase beyond this level at the start of the following income year. Therefore, understanding the time restraints to leverage such rules is critical.

Trustees may also wish to contemplate the potential addition of other members (e.g. adult children) to benefit from such reserve allocations. Once again, consideration of each person's TSB will be integral to the allocation strategy from any fund reserves.

Specific reserve account created in the past

These reserve accounts are likely to have been created and maintained with a specific purpose in mind, but in many cases a lack of understanding by the service provider or trustee has left them untended and becoming an ever-increasing problem.

In more recent times, a "drip feed" approach might have been used to allocate the reserve across the member accounts in the fund, without triggering excess contribution provisions, but the reserves could be significant relative to the ongoing member balances. Recent allocations of reserves will likely reduce the "optimum" amount which can be allocated without incurring personal tax.

---

[15] *Income Tax Assessment Act 1997* Section 291.15

What does the trust deed say ?

When we talk about allocating reserves, we talk on a generic basis. When we need to know what we can actually do we need to "read the deed". Not all trust deeds contain explicit provisions about allocating reserves and the absence of "enabling" clauses can potentially restrict effective actions in the event of a significant "wipe out" event, such as the death of a member for example.

What are features which could prove helpful in relation to reserve allocation?

- specific provision enabling reserves to be in place,
- trustee discretion to allocate reserves,
- ability to allocate reserves to current and former members, and
- trustee discretion to allocate reserves to members on exit, both voluntary and involuntary (i.e. death).

As well as features relating to reserves, we also need to look for features which enable the fund to continue despite the death of the sole or principal member, such as:

- the ability for the fund to continue with the trustee allowed to admit new members, even after the death of the sole member,
- confirmation that the fund does not terminate unless the trustee resolves to do so, despite there being no active members at the time of that decision, and
- confirmation that a member does not cease to be a member until the trustee resolves that their interest in the fund has ceased.

These provisions are suggested to ensure that the trustee has maximum flexibility in the application of any reserves in the future.

Potential wipeout event – death of an account based member

This is the lesser of the problems when we are looking at the treatment of reserves. The trust deed is likely (see above discussion) to contain provision for reserves to be allocated to supplement the benefits if an exiting member, including a death benefit.

Depending on the amount of reserves, and the contribution history of the members of the fund, it might not be possible to allocate the full reserve in a tax effective manner. This is where trade-offs need to be considered, looking at the least unfavourable tax and access outcomes if there are limited potential options for allocating to members of the fund.

If it is possible to introduce other family members to the fund, it might be possible to drip feed the remaining reserve to those members over time. Of course, if these members have yet to satisfy a condition of release the reserve allocation will not be accessible to them until they meet a condition of release.

Each of these actions needs to be consistent with the provisions of the trust deed.

Potential wipeout event – completion of a complying pension

If the complying pension recipient also has an account-based pension or accumulation account in place, there is less of an issue and the comments in the above section are relevant.

The more significant issue occurs where the only "account" related to the complying pensioner and the common view is that the person ceases to have membership when that pension completes, for example a term pension completing its nominated term of payment.

The provisions of the trust deed become important at this stage to determine whether it is possible to allocate reserves to the recently completed pensioner or recently deceased pensioner. In the absence of that opportunity there may be a limited field of potential recipients for an immediate or ongoing reserve allocation.

5. Planning before the event

The common theme underlying each of these potential "wipe out" outcomes is that trustees need to be prepared in advance and appropriately educated on what to look out for. This does not mean that they need to know all of the answers, but they need to know when to engage with the professional adviser before the problem either emerges or worsens.

Therein lies the problem!

There is a greater need for SMSF trustees to engage with their professional adviser during the year rather than after the end of the year. As stated earlier, the trustee is fully responsible and is in full control of their actions, but they can't take their SMSF for granted in the same what that a family trust or personally held investment can be adaptive around what they do.

We are really "preaching to the converted" here, how do we get our clients to help us help them?