Separate SMSFs for collectables

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Abstract: As part of the superannuation reforms which came into effect on 1 July 2017, self-managed superannuation funds (SMSFs) with at least one member in receipt of a retirement phase income stream, with a total superannuation balance over $1.6m, are no longer able to use the segregated method to calculate exempt current pension income (ECPI). One strategy which emerged to counter this restriction involved achieving a "quasi segregation" via separate SMSFs. The Australian Taxation Office (ATO) has expressed the view that this will only be acceptable in limited circumstances and where the aim is not to manipulate taxation outcomes. This article examines the holding of "collectables" by an SMSF as a circumstance where a separate SMSF might be strategically useful as well as acceptable from an ATO point of view.

Introduction

There was chatter a couple of years ago concerning a strategy that had emerged. The strategy is referred to in this article as the "two-SMSF strategy". A two-SMSF strategy is simply a strategy whereby a member, or members, establishes a separate self-managed superannuation fund (SMSF) to hold specific assets. Much of the context of the chatter concerned saving tax by getting around the new restriction on using the segregated method to calculate an SMSFs exempt current pension income. It made sense. The Australian Taxation Office (ATO) squashed it, however, with a hint toward the anti-avoidance provisions. The initial ATO position seems to be well encapsulated here:[1]

> "Considering the *additional administrative costs and processes* associated with establishing a separate SMSF and transferring selected assets from an existing SMSF to a newly established SMSF, together with the ongoing costs of maintaining an additional SMSF, prima facie there *does not appear to be any explicable reason* for doing so other than for the purpose of creating a more beneficial tax outcome under the superannuation new measures that come into effect on 1 July 2017." (emphasis added)

Many industry commentators made submissions to the ATO and included estate planning as a very legitimate non-tax reason for wanting to implement a two-SMSF strategy. The ATO's latest position seems to have taken those submissions on board:[2]

> "Whilst the establishment of a second SMSF by itself does not give rise to compliance issues, we will further examine the circumstances of those cases where it appears that the establishment of a second SMSF *has been a pre–cursor to subsequent behaviour intended to manipulate tax outcomes*. This behaviour could include, for example, switching each of the respective funds between accumulation and retirement phase." (emphasis added)

A person needs to have a good reason for adopting the two-SMSF strategy. It would appear that estate planning is a legitimate reason to adopt the two-SMSF strategy so long as there are no manipulated tax planning benefits coming to pass.

One worthy estate planning reason arises due to the sentimental value which attaches to certain investments such as art, wine, jewellery and cars. This makes the two-SMSF strategy an appealing estate planning strategy for members of SMSFs that hold investments in "collectables".[3] Many SMSFs hold investments in collectables which have significant emotional, as well as dollar, value. This article explores the two-SMSF strategy as an estate planning tool for SMSFs which currently hold, or acquire, collectables.

The ATO position on whether this is an "explicable" reason for having an additional SMSF is unknown to the authors. An SMSF member contemplating a two-SMSF strategy might consider applying for a private ruling and should seek appropriate advice in light of their specific circumstances.

Example

Consider Bill and Barbara. They are the only two members of an SMSF. They are the joint shareholders and directors of the trustee company. It is 1 July and they have both just turned 65. They both want to commence a pension from the SMSF. While preparing the documentation to commence the pension, they take the opportunity to consider the estate planning issues and to update their wills.

Bill and Barbara are trouble-free financially. They don't have any concerns. They have a nice house and they have investments outside superannuation. They have been successful. The SMSF has $3m in assets. They each have balances of $1.5m (under the transfer balance cap of $1.6m) so the fund will become a fully "tax-free" pension fund. The assets of the fund are $2.6m in ASX-listed shares and $400,000 in "collectables".

The collectables are acceptable from a compliance point of view. Bill and Barbara have always complied with the *Superannuation Industry (Supervision) Act 1993* (Cth) (SISA) and the *Superannuation Industry (Supervision) Regulations 1994* (Cth) (SISR).[4] They did not accumulate the collectables in their SMSF in order to try and obtain present day benefits through the fund (which of course would be a breach of the sole purpose test[5]). It happened this way because, over time, the SMSF had the "cash" to purchase the collectables at opportune times. Most of Bill and Barbara's private, after tax, cash was tied up in other projects, like mortgage payments and school fees. Their "spare" cash was in their SMSF. They have made astute collectable investments over the last thirty years or so which are now worth $400,000. Bill and Barbara consider that, after their home, the collectables are their "favourite" assets.

Bill and Barbara have four adult children between 30 and 40 years old. One child has always shared Bill and Barbara's love for collectables (the collectable-child (CC)). Everybody in the family group knows that and it has always been understood that the CC will end up with the collectables owned by the SMSF. The CC is doing quite well financially. So is one of the other children. The other two children are making things work. However, with mortgage payments and school fees, etc, they aren't managing to do any saving. None of the children are financially dependent on Bill or Barbara.

Bill and Barbara go to their lawyer. They have what they think is a relatively simple request for their SMSF. They both want "the SMSF" to go 25% to each child. In addition, they would like for the entirety of the collectables to form part of the payment to the CC in the form of an in specie transfer of the collectables from the SMSF. The balances (after taking account of the value of the collectables transferred to the CC) are to be paid to each child as cash lump sums after liquidating the shares. They have discussed it with their children who have all agreed. Bill and Barbara feel this to be a reasonable position because the collectables are valued at 13.33% ($400,000/$3m) of the fund. They feel that when the time comes, the collectables can be transferred to the CC. Then, the balance to make up her 25% can be paid out as cash.

Bill's and Barbara's wills pass control of the trustee company so that on their death, the four adult children can equally take control of the SMSF as shareholders and directors of the trustee company. Everyone is happy with this arrangement. Bill and Barbara have heard all about binding death benefit nominations (BDBNs) and request for them to be prepared. At this point, a couple of questions arise:

(1) Can a member bind a trustee of an SMSF to pay a death benefit as an in specie transfer?

(2) If a member can, what are the potential pitfalls if they do?

The remainder of this article discusses those questions and suggests a two-SMSF strategy as a possible solution.

Can a member bind a trustee to pay a death benefit as an in specie transfer?

A superannuation death benefit is a benefit provided to a person, or to the trustee of a deceased estate, in the event of the death of a member.[6] A member's benefits must be cashed as soon as practicable after the member's death.[7] The terms of the trust deed, as opposed to the member's will, determines how, and to whom, a death benefit can be paid.[8] However, there are legislative provisos also. The deceased's dependants[9] can usually receive a death benefit in the form of either a superannuation income stream or a lump sum, or a combination of both.[10] However, a death benefit can only be paid to a child of the deceased in the form of a superannuation income stream if that child is less than 18 years of age,[11] ignoring possible financial interdependency or disability.[12] A death benefit payment can only be made to the deceased's adult children, therefore, in the form a lump sum.[13]

> *"This makes the two-SMSF strategy an appealing estate planning strategy for members of SMSFs that hold investments in 'collectables'."*

Where permitted under the fund's governing rules, a lump sum payment may be in the form of cash or in specie. An in specie payment is made with fund assets (eg shares in company, business real property, or collectables as discussed in this article) rather than money. When making an in specie transfer, trustees must be able to substantiate the value of the relevant asset or assets for both SIS[14] and taxation[15] purposes. Death benefits in the form of a superannuation income stream cannot be paid in specie; this is because the definition of a "lump sum" under the superannuation law includes an asset. However, there is no equivalent definition for an income stream.

Therefore, subject to the fund's governing rules potentially precluding the ability to do so, members can bind the trustee as to the lump sum payment of death benefits being in specie, rather than in cash.

Are there potential pitfalls in binding a trustee to an in specie payment?

Adhering to a binding nomination could come at the cost of other death benefit beneficiaries. It can also lead to angst and friction.

Updated facts on Bill and Barbara

It is seven years later. Bill and Barbara pass away in an accident. All four children become directors of the trustee company. They turn to the payment of the 25% each out of the SMSF as required by the BDBNs prepared when the pensions began. It becomes apparent that the value of the collectables might be more than 25% of the fund.

How could this happen?

If the collectables hit a small bull market over the seven-year period, the "value" of the collectables could easily be more than the 25% share that the CC is entitled to. If the true value is more than 25% of the value of the fund, the other three children could feel they are getting short-changed. The CC really wants the collectables. The CC does not see it as a problem and doesn't want the collectables liquidated for cash. But the CC is not struggling for cash. In contrast, two of the children are. So they do see it as a problem. Everybody knows Bill and Barbara did not want the collectables liquidated. However, it is looking like a 50/50 split on what to actually do, because the two children who are doing well financially are happy to let any discrepancies slide, in order to bring effect to Bill and Barbara's wishes, in respect of their "favourite assets". The other two children want the cash. Quickly. Everyone agrees that litigating over the validity of a BDBN is likely to be expensive all round and stressful on the family dynamic. It's a bit of a mess and nobody knows what to do.

Some fairly benign and non-controversial assumptions can easily lead to this outcome. Table 1 illustrates a fact scenario that is not difficult to fathom.

Bill and Barbara took the statutory minimum pensions of 5% from their fund every year for the seven years. The shares

Table 1. Relative increase in collectables over seven years

		Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	End of seventh year
Collectables		40,000	440,000	484,000	532,400	585,640	644,204	708,624	779,487
Shares/cash		2,600,000	2,549,000	2,496,510	2,442,345	2,386,301	2,328,156	2,267,665	2,204,557
Value at 1 July		**3,000,000**	**2,989,000**	**2,980,510**	**2,974,745**	**2,971,941**	**2,972,360**	**2,976,289**	**2,984,044**
Dividends from shares and interest	4%	104,000	101,960	99,860	97,694	95,452	93,126	90,707	682,799
Growth on collectables value	10%	40,000	44,000	48,400	53,240	58,564	64,420	70,862	379,487
Taxes	0%	–	–	–	–	–	–	–	–
Minimum pension payments	5%	150,000	149,450	149,026	148,737	148,597	148,618	148,814	1,043,242
Insurance and storage for collectables		5,000	5,000	5,000	5,000	5,000	5,000	5,000	35,000
Movement in cash		–51,000	–52,490	–54,165	–56,043	–58,145	–60,492	–63,108	–395,443
End collectables		440,000	484,000	532,400	585,640	644,204	708,624	779,487	
End shares/cash		2,549,000	2,496,510	2,442,345	2,386,301	2,328,156	2,267,665	2,204,557	
Value at year end		**2,989,000**	**2,980,510**	**2,974,745**	**2,971,941**	**2,972,360**	**2,976,289**	**2,984,044**	

Start of the period collectable value	400,000	End of the period collectable value	779,487
Start of the period collectable %	**13.33%**	**End of the period collectable %**	**26.12%**

paid an income yield of 4%. However, somewhat controversially possibly, there was no capital growth. (This is for ease of calculation. The important aspect is the *relative* growth in the asset classes.) The collectables happened to go through a growth spurt of 10% each year but did not yield any income (through rental of art to corporate lobbies, for example). They were simply stored and insured. After seven years of benign numbers like that, the scenario becomes one in which the value of the collectables results in a situation that seems "unfair" or grey. The more the collectables go up in value relative to the shares, the more unfair it becomes. Classic cars as a global asset class rose by a staggering 334% in the last 10 or so years.[16]

The real problem here is that the perceived unfairness is causing uncertainty over the critical assets, being the collectables. How are all four children kept happy with the "amount" they get, but with the collectables also being transferred to the CC? Isn't the most convenient, reasonable and likely solution found in liquidating all of the assets and paying the death benefits in cash? But that is precisely what Bill and Barbara did *not* want. Doing so would also expose the trustee (the directors) to legal action in respect of not following a valid BDBN.

How might a two-SMSF strategy help?

When Bill and Barbara commenced their pensions, they could have established SMSF No. 2 and transferred the collectables to that fund. Bill and Barbara could have made BDBNs directing 100% of the death benefit from SMSF No. 2 to be paid to the CC. Control of the trustee company could have been passed to the CC under their wills. The CC could then exercise a discretion to pay the death benefit as an in specie transfer of some, or all, of the collectables. Bill and Barbara's wishes in respect of the collectables would have easily been satisfied.

A two-SMSF strategy would not alleviate the potential unfairness, financially, of the CC ending up with the collectables worth more than 25% of the "overall pie". However, it would quarantine those collectables. The CC would control what happens with those. The children could argue over how the death benefits from the original fund might be adjusted for the value of the collectables which would have already gone to the CC. Perhaps the CC might sell some of the collectables and make some cash payments to the other children if the CC believed she got a better deal, financially, than planned. There might be some argument over how much should be paid to make up any differences. However, at least the ultimate fate of the collectables would rest in the CC's hands and not, potentially, the court's.

Tax benefits

Note that, in the example above, neither Bill nor Barbara have pension accounts over $1.6m. Their fund is 100% "tax-free". However, with a slight change in the facts, a tax benefit appears. Assume an SMSF with only one member. The same $2.6m in shares and $400,000 in collectables. A $3m fund. Approximately 53% ($1.6m/$3m) of the fund's assessable income is likely to be exempt from tax (exempt current pension income (ECPI)).

Collectables are precisely the type of asset you would segregate, if you could, using a two-SMSF strategy to reduce tax. They are long-term, low income, capital gains tax (CGT) assets. They are the types of assets that would go into a segregated accumulation fund, if the ATO would allow it. By taking the collectables out of a "pension paying fund", the value of the fund decreases. So more of the value of that fund gets taken up by the actual pension value. ECPI is calculated at the fund level and doesn't take into account superannuation balances in other funds. This leads to a higher ECPI percentage and more income being sheltered from income tax. In this new example, if the collectables were in a separate SMSF, the ECPI percentage becomes approximately 62% ($1.6m/$2.6m), an approximate increase of 10%. This comes without an immediate or annual tax cost at the second SMSF level. Collectables are often low income-yield assets and tax, if there is any, will be assessed under the concessional CGT regime, at some time in the future, if the collectables end up being sold. There will be a CGT event for the transferring SMSF. Unless the transfer is consequent on a marriage breakdown, there would appear to be no exemption or roll-over available. The transferring SMSF would be able to minimise the CGT impost in the usual manner — applying any carried forward capital losses, applying the CGT discount and the ECPI percentage.

The "additional administrative costs and processes" associated with establishing a separate SMSF

Of course, individual firms have different ways of being paid, but it is suggested that the costs associated with a second SMSF for collectables would not necessarily be high. In fact, they could be quite low. The initial set-up processes and costs are well understood by existing SMSF trustees and are not burdensome. The second SMSF would, in all likelihood, end up with a small number of assets. Fully insured and stored properly. The valuations have to be done whether there is one fund or two. An additional audit fee will need to be considered, although it is suggested that the auditor of the original fund, who will likely audit the second fund, would be familiar with the collectables already. The auditor will know the trustees and the governing rules of the second SMSF, as they will probably be the same as those governing the first SMSF. Therefore, much of the work an auditor would need to do for the second fund is being done for the first fund. There is not a huge change in what needs to be done than if the first fund still owned the collectables. To the extent that a second SMSF would cause additional administrative costs and processes, they do not appear to be particularly onerous.

Conclusion

For members of SMSFs which hold investments in collectables, a two-SMSF strategy might be a useful tool in their estate planning toolkit. The extra costs associated with the strategy might be worth it for the peace of mind and certainty that can be obtained by quarantining collectable assets for estate planning. In some cases, the dollar cost might also be offset by tax savings.

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References

1 S Patten, "Multiple SMSF strategy may prove illegal", *The Australian Financial Review*, 24 April 2017.

2 ATO, "Super changes – frequently asked questions". Available at www.ato.gov.au/individuals/super/in-detail/super-changes---faqs/#Selfmanagedsuperannuationfund SMSFtrustee.

3 See s 62A of the *Superannuation Industry (Supervision) Act 1993* (Cth) (SISA) for a list of assets which fit the definition of "collectables".

4 See reg 13.18AA of the *Superannuation Industry (Supervision) Regulations 1994* (Cth) (SISR) for the compliance hurdles in respect of investments in collectables.

5 S 62 SISA.

6 S 68AA(10) SISA; reg 6.21 SISR.

7 Reg 6.21(1) SISR.

8 *McFadden v Public Trustee for Victoria* [1981] 1 NSWLR 15 at 22.

9 Defined in s 10 SISA.

10 Reg 6.21(2) SISR.

11 Reg 6.21(2A)(b)(i) SISR.

12 Reg 6.21(2A)(b)(ii)(A) and (B) SISR.

13 The taxation consequences are governed by a slightly different definition of "dependant". Section 302-195 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) essentially provides the distinction that, for tax purposes, an adult child of the deceased will *not* be a death benefits dependant unless there is some form of interdependency relationship. Generally, therefore, death benefits received by adult children of the deceased are subject to a 15% tax.

14 For instance, the requirement for arm's length dealings in s 109 SISA, the standards prescribed by s 62A SISA (as picked up by reg 13.18AA SISR), s 65(1)(b) SISA (that prohibits a fund from inappropriately providing value to members) and the obligations invoked by the operating standards in Pt 3 SISA (this is not an exhaustive list).

15 For instance, the market value substitution rule in s 112-20(1)(c) ITAA97 (this, again, is not an exhaustive list).

16 Knight Frank, "The wealth report". Available at www.knightfrank.com/wealthreport/2018/luxury-spending/luxury-investment-index-2018.

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