SMSF BORROWING – DEALING WITH LUMPY ASSETS

This article examines the concept of managing lumpy assets in a self-managed superfund.

When the trustee of a SMSF considers borrowing to acquire real estate, consideration is often given to:

- the potential investment gains to be made;
- the benefits of borrowing; and
- managing the loan payments.

What is often overlooked is a less immediate issue - what happens with the 'lumpy' asset following the death of a member of the SMSF.

What is a lumpy asset?

An asset would generally be considered to be a lumpy asset when it represents a significant proportion of the total assets of a SMSF, and it is relatively illiquid. Real estate is the most common form of lumpy asset within a SMSF.

During the course of a borrowing arrangement, as available funds are usually applied to reduce the loan, the acquired asset is likely to be more significant in terms of percentage of overall assets than a property may be in a SMSF with a range of investments.

Problems with a lumpy asset

On the death of a member, the assets of a SMSF must be dealt with by either providing for pensions or paying lump sums to beneficiaries.

Superannuation pensions have minimum payment levels to be met which, in any event, could be less than the income the dependent requires. With the national rental return from residential property in 2011 at 4.3% (propertyobserver.com.au), the return from the lumpy asset may not be sufficient to meet the pension requirements. As a result, the property may need to be sold at an inopportune time.

When a lump sum payment is required, for example when the payment is to be made to a number of adult children, the asset may need to be split amongst each of the children.

Property tends to be held within superannuation for a longer time than more liquid assets such as shares. Potentially, the capital gains tax liability, which is likely to be triggered by the transfer, will be significant. That will be payable in addition to death benefits tax of 16.5%.

Note:

Although the issue of capital gains tax has generally been removed in the case of death benefits paid from SMSFs following the death of a pension recipient, it is still a possibility when no pension was being paid at the time of death (i.e. when the SMSF was in accumulation mode).

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What options are available to deal with lumpy assets?

Properly detailed pre and post retirement planning can reduce the tax impact and, possibly, allow the property to be retained in the SMSF. That can be achieved through a combination of operating a reserve within the SMSF, holding insurance on the lives of the members, utilising cash available to reduce potential death benefits tax and having the adult children become members of the SMSF.

Keeping the property in the SMSF?

It is possible for intergenerational transfers to occur within a SMSF, usually through the use of insurance and planning with reserves.

As the reserve does not become part of the benefit account of any member, it does not need to be paid out on the death of a member. If the insurance proceeds are paid to that reserve, the cash from the insurance claim could fund the payment of the benefits, allowing the property to remain in the SMSF for the next generation.

What happens to the reserve?

The reserve can be gradually eroded by way of allocation to the members (i.e. the children). The allocation will not be treated as a concessional contribution so long as the amount allocated:

- is allocated in a fair and reasonable manner to every member; and
- is less than 5% of a member's account balance before the reserve amount is allocated.

Summary

Insurance has a very important role to play within SMSFs with borrowings. Proper planning and structuring is needed, however, to ensure that the asset acquired can be dealt with as planned, without incurring significant taxes.

More information

Should you have any queries, or require more information, please contact the team at Topdocs on 1300 659 242.

Current as at 11 November 2013.
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