When SMSF members head for the exit

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Julie Steed

Establishment and growth of SMSFs receives plenty of coverage in the media, but relatively little attention is paid to the other end of the SMSF life cycle – when an SMSF is no longer appropriate for one or more of its members. ATO data shows about 1,000 SMSFs are wound up each month.

The increasing number of Australians living with dementia and Alzheimer's has encouraged some SMSF members to look at alternatives and there are circumstances where the members may need an exit strategy. The three main alternatives are:

- rollover to a retail or industry fund
- convert to a Small APRA Fund (SAF), as discussed previously in Cuffelinks here.
- pay benefits to members and close down the SMSF.

More on these choices later.

Why do some trustees wind up their SMSF?

It is important to consider the attitudes and abilities of the remaining SMSF members if one or more members die or are no longer able to be a trustee, perhaps due to declining physical or mental health. Will the surviving members want to continue the fund? Do they have the necessary skills, time and interest levels?

An exit strategy may also be needed due to the fund's investments. Does the fund have illiquid or indivisible assets that may affect its ability to make benefit payments?

The following 'Ds' are all trigger events that may lead to the need for an exit strategy:

Death and disability: The payment of a death or disability benefit is an important issue if indivisible or illiquid assets are involved, or if there are unique assets the family unit wishes to retain.

Dementia: If an SMSF trustee loses mental capacity they are legally unable to continue in the role of trustee and therefore unable to be a member of an SMSF. However, there are no legal issues with a person who lacks mental capacity being a member of a retail fund or a SAF.

Disinterest: Loss of interest can be a driving factor for many SMSF trustees who are skilled and committed at the outset but may become less interested and able as they age.

Divorce: When couples in an SMSF separate it is often highly desirable for each member to make their own future super arrangements. Running an SMSF with trustees who are not on good terms is difficult at best and often impossible. Additionally, if a family law split is being made from the SMSF, it is possible to take advantage of the capital gains tax (CGT) exemptions when moving one of the parties to a SAF or a new SMSF. However, this is generally not available if the family law split is paid to a retail fund.

Departed residents: If an SMSF member becomes a non-resident, it can be difficult for the SMSF to retain its eligibility for concessional tax treatment. There are generally no issues for departed members in retail funds. SAFs can also have non-resident members, however the members can generally not contribute.

Disqualified persons: A disqualified person is either an undischarged bankrupt or someone who has been convicted of an offence involving dishonesty. A disqualified person cannot legally be a trustee and is therefore unable to be an SMSF member. There are no issues with a disqualified person being a member of a retail fund or a SAF.

The three exit strategies have different tax outcomes, different abilities to retain private assets and different administrative requirements.

1. Rolling over to a retail or industry fund

Rolling over to a retail or industry fund is a CGT event. Any gains will be realised and tax payable. If capital losses exist, they cannot be carried forward. If members are in pension phase this may not be an issue, however it may be a significant cost if the fund is still in accumulation phase.

The range of investment options may also be a significant factor. It is important to compare the SMSF's existing investments with those available in a new fund. If the SMSF has assets that cannot be accepted, how do the members feel about disposing of the assets? This may be an issue if the SMSF has real property, collectables or shares in private companies. If the SMSF has a residential apartment on the Gold Coast, the SMSF members may be perfectly comfortable in selling the property to facilitate a move to a retail fund. However, if it's a property that SMSF members are running the family business from, its sale may be highly undesirable.

For members who commenced a pension before 1 January 2015, any Centrelink deeming exemption will be lost if the pension is rolled over to a new fund. This may result in a reduction in age pension.

2. Converting to a small APRA fund

A SAF is an SMSF with a professional licensed trustee. The professional trustee manages the fund for the benefit of the members and is responsible for all of the fund's compliance, regulatory reporting, and administration.

This conversion can avoid CGT entirely. The existing trustees simply retire and appoint the professional trustee. The fund (the tax paying entity) continues uninterrupted and does not dispose of any assets; there is simply a change in trustee.

Moving to a SAF may also help members who wish to retain unique investments. Different SAF trustees will have their own rules in respect of allowable assets, however a SAF will be far more likely to accept a unique asset than a retail or industry fund. Provided that the total fund investments are relatively diversified, it is common for SAFs to allow holdings of real property, private company shares and collectables.

Importantly, converting an SMSF to a SAF does not have any implications for the grandfathering of Centrelink deeming on pensions.

3. Paying benefits and closing the SMSF

If the members have met a condition of release it is possible to simply pay the member benefits and wind-up the SMSF. Sufficient funds will be retained for wind-up costs and taxes and a final return will be lodged.

Naturally, the member needs to compare the tax-effective environment of superannuation with other forms of investments. This decision is often balanced with the expense of running an SMSF that has been paying a pension for many years and now has a relatively low account balance. There may also be Centrelink implications of cashing benefits from an SMSF.

An exit strategy may not be something that SMSF members think about often, but there are a number of instances in which one may be required. Taking steps to identify the potential trigger events and available strategies will assist members to better achieve their retirement goals, even when things don't go to plan.

Julie Steed is Senior Technical Services Manager at Australian Executor Trustees. This article is general information and does not consider the circumstances of any individual.

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