TECE Update

ATO view on funding SMSFs and insurance – Tips on investment strategy and using insurance for liquidity or cash flow purposes

Life's better with the right partner®

The Australian Securities and Investments Commission (ASIC) has issued an information sheet (INFO 205) for advisers providing personal advice to clients about a self-managed superannuation fund (SMSF). The guidance provides an indication, via 'compliance tips', of what ASIC is likely to scrutinise during their day-to-day surveillance activities. ASIC expect to see advisers disclosing the risks and costs of operating an SMSF as well as the potential benefits that may be lost by switching to an SMSF.

This article gives context to some of the risks that ASIC have identified and the implications this could have when providing advice to clients about insurance for their SMSF investment strategy.

ASIC 'compliance tips' for the SMSF investment strategy:

- **ASIC is likely to look at the advice clients receive about their SMSF investment strategy and in particular whether appropriate insurance cover has been considered for members**
- **Where a limited recourse borrowing arrangement is recommended, trustees should be provided with an explanation of the associated risks**

As an example, let's consider a two member husband/wife SMSF (corporate trustee) established several years ago. The SMSF entered into a limited recourse borrowing arrangement (LRBA) and used the proceeds, together with the couple's super balances at the time, to purchase an investment property. Apart from a small amount of cash in the SMSF bank account, the SMSF has no other assets. The SMSF does not own any insurance policies.

The husband suddenly passes away. For the past few years his employer super guarantee (SG) contributions, together with the rental income from the investment property, provided the SMSF with adequate cash flow to make the required principal and interest repayments on the property. But with the husband's SG contributions ceasing, the cash flow position of the fund is put under pressure and the bank is concerned about the ongoing serviceability of the loan, especially given the wife is a volunteer worker for a local charity.

Apart from the obvious lack of asset diversification, what could ASIC scrutinise if they looked at the investment strategy advice provided by the adviser to the directors of this SMSF?

Based on the guidance released by ASIC, the following factors could arguably attract their attention:

- Whether or not the advice was appropriate to the risk appetite and investment goals of the clients.
- To what extent has the fund's investment strategy considered the likely cash flow position of the fund in light of a substantial change in circumstances, i.e. increases to loan interest rates, protracted periods of rental vacancies, decreasing rental yields, the death of a member etc.
- Whether the directors, as part of the development of the fund's investment strategy, had considered taking out insurance cover for themselves as members of the SMSF.

How insurance could have helped...

Let's imagine that the SMSF did own an insurance policy on the husband's life. After he passed away, the ensuing payment of cash could have been used to extinguish the debt and alleviate any of the cash flow pressures. From there, the fund could have been in a position to retain the investment property (at least in the first instance), then proceeded to commence a death benefit income stream for the wife, using her husband's prevailing account balance as the purchase price .

But perhaps more importantly, the liquidity created by the insurance policy would avoid the wife being forced into the position of an immediate 'fire sale' of the investment property following her husband's death. In other words, the ability to repay the debt eliminates the likelihood of the bank demanding a sale of the property (perhaps due to a specific clause in the loan agreement), or because the resultant cash flow pressures leave the wife, as surviving director, with no choice but to dispose of the property in order to extinguish the debt.

That's why the role of the adviser is so crucial when it comes to formulation of an SMSF investment strategy. Super law requires trustees to consider whether it's appropriate to hold insurance cover for its members. This 'compliance tip' serves as a reminder of the role that advice about insurance can play for SMSFs that anticipate a lack of sufficient liquidity following the death or disability of a fund member.

ASIC compliance tip: clients should be advised of an appropriate SMSF exit strategy

The death or incapacity of the more active SMSF trustee/director may trigger the eventual wind up of an SMSF. Take our two member husband/wife SMSF. If the husband was the more active director, then in the interests of simplification, the wife may decide to wind up the SMSF and rollover her super to a public offer fund.

An SMSF-owned insurance policy not only creates liquidity, it can also lay the foundation for an exit strategy if the wife subsequently decides to windup the SMSF. That's because the extinguishment of the debt provides 'breathing space' which effectively puts her in a position, as surviving director, to arrange for the sale of the property to coincide with an eventual windup of the SMSF. Contrast that with a fire sale of the property, which introduces an element of market risk and may consequently lead to a messy exit from the SMSF.

So the benefits of having SMSF-owned insurance cover on the lives of its members are twofold; it can provide a crucial source of fund liquidity while also laying the platform for an orderly SMSF exit strategy.

Business partners as co-members of an SMSF need a robust exit strategy

We know that one reason business partners establish an SMSF together is so they can house the business premises within their SMSF and lease it back to the business on commercial terms. This provides a tax effective way to accumulate superannuation savings given the obligation on the part of the business partners to pay arm's length rent to the SMSF for the life of the lease agreement.

But it's important that such arrangements are underpinned by a robust exit strategy that caters for the unexpected death or incapacity of one of the business partners. That's because the death of a business partner/member necessitates the payment of a corresponding super death benefit under super law. And as is usually the case with these SMSFs, the primary asset of the fund is the commercial property itself, so the fund typically lacks the liquidity to pay the required lump sum death benefit.

To illustrate this conundrum, when a co-business partner/member passes away within an SMSF that primarily owns commercial property (assuming no LRBA), a survivor business partner will generally have the following options:

1) Pay the nominated beneficiary a cash lump sum death benefit, using the sale proceeds from disposal

of the commercial property or via the injection of a large cash contribution by the surviving member or an incoming member.

2) Pay the nominated beneficiary an in-specie death benefit using part of the commercial property.
3) Pay the nominated beneficiary a death benefit income stream.

Arguably Options 1 and 2 are not commercially viable, particularly if the survivor business partner intends to retain the property for use in the business. Option 3 is generally only a possibility where the beneficiary is the spouse or minor child of the deceased member and would require the recipient of a death benefit income steam (i.e. widow or child/child's representative) to be admitted as a member and trustee/director of the SMSF. This could in theory lead to future disputes, particularly if the business partner and widow are at odds about the investment strategy of the fund going forward.

So, again, this compliance tip is an important reminder. When the liquidity of the fund is constrained – typically because the primary asset of the fund is the actual business premises of the member trustees/directors – it becomes difficult for a surviving business partner to maintain status quo while simultaneously meeting their obligations to pay a death benefit upon the passing of a business partner/member. An exit strategy therefore, is a must.

Could the SMSF own an insurance policy to underpin an exit strategy?

Since changes to super law from 1 July 2014, the establishment of insurance policies within an SMSF to provide liquidity on death or incapacity of member business partners, has been somewhat complicated. That's because in the past, liquidity could be provided via ownership of so called 'cross insurance' policies. The effect of these policies was to credit the survivor business partner's SMSF account with the applicable sum insured on the death of the co-business partner/member (the life insured). The cash proceeds from the insurance policy would in turn be utilised to pay the required lump sum death benefit and the survivor business partner would be able to retain the business premises within the SMSF going forward.

But according to the Australian Taxation Office, changes to super law that took effect from 1 July 2014 prohibit SMSFs from establishing cross-insurance policies for these purposes.

So what liquidity solutions are available to a business partner SMSF when planning for an exit strategy?

There's a technical view that an SMSF insurance reserve could be utilised to provide the required liquidity. However, this is likely to create significant asset holdings within the reserve, which can result in more complexity given the restrictions imposed on distributions of reserve holdings to member accounts and current contribution caps.

One option is for the business partners to 'cross-own' life insurance policies outside of super. That way, the survivor business partner can receive the relevant sum insured then inject the proceeds into the SMSF by way of a non-concessional contribution. The cash can then be used by the SMSF to pay the lump sum death benefit and the commercial property can be retained within the SMSF.

The effectiveness of this strategy is of course constrained by the non-concessional contributions cap. There may be workarounds such as making a cash contribution on behalf of a spouse or arranging for the survivor business partner to partially acquire the property from the fund. However, these strategies require careful examination and are outside the scope of this paper.

Final observations

If you have clients implementing an SMSF investment strategy that involves 'lumpy' illiquid assets, ensure consideration has been given to a robust exit strategy. Insurance can have an important role to play in providing liquidity to an SMSF and can provide a platform for an eventual exit strategy. This of course, needs to be balanced against underwriting and insurability constraints.

As always, make sure the fund's trust deed provides sufficient latitude to enable the implementation of the appropriate strategy and that expert technical and legal advice is being obtained where necessary.

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