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SMSF Tax Update

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Abstract

This paper looks at several things with respect to getting value into an SMSF. First, it looks at recent budget changes that will increase the amount of contributions that can be made to a SMSF. Secondly, it looks at 'vanilla' or traditional strategies currently used in practice to get value into a SMSF. Thirdly it discusses recent ATO 'products' (ATOIDs and Taxpayer Alerts) that relate to contributions. Finally, it looks at some issues around allocation from reserves in a SMSF and how they relate to contribution caps, assessable contributions in the SMSF and taxable component of a benefit payment.

SMSF TAX UPDATE

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SMSFs are, since the changes made to the way that they are taxed in 2007, clearly the 'vehicle of choice' for people to hold their private wealth. Simply put, once the member is over age 60 and the SMSF is in pension mode then, in effect, what you have is a private family trust that does not pay any tax at all. Of course, things are never as easy as that and, at last count there is over 2500 pages of tax and compliance rules that need to be managed to get that result.

Interestingly, until the changes were made in 2007 most of that compliance focus was directed at people taking money out of a SMSF before they should have. After 2007 the game changed and now the focus of compliance is to prevent people from getting more value into their SMSF than is considered appropriate. In this context, the contribution caps measure what is considered appropriate.

In light of that change in direction this paper looks at several things with respect to getting value into an SMSF:

First, it looks at recent budget changes that will increase the amount of contributions that can be made to a SMSF,

Secondly, it looks at 'vanilla' or traditional strategies currently used in practice to get value into a SMSF,

Thirdly it discusses recent ATO 'products' (ATOIDs and Taxpayer Alerts) that relate to contributions, and

Finally, it looks at some issues around allocation from reserves in a SMSF and how they relate to contribution caps, assessable contributions in the SMSF and taxable component of a benefit payment.

BUDGET CHANGES THAT INCREASE CONTRIBUTIONS TO SMSF

There are three (potential) Government announcements that will increase the contributions that can be made to an SMSF:

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First, the concessional contributions cap for individuals who are over age 50 whose account balance is less than \$500,000 will be \$50,000 from 2013. There is no time limit on this doubling of the concessional contributions cap, as there was for the transitional doubling of the contributions cap, which is due to expire by 2012.

At first glance it is not obvious who would use the double concessional cap because if your account balance is less than \$500,000 by your fifties then that probably means that you are not a high income earner, which, in turn, means that being able to contribute \$50,000 pa of pre tax contributions is nice in theory but, so what.

However, clearly this measure is intended for high income earning individuals who have had broken work patterns that have prevented them from getting a large account balance. Effectively, that means females who may have been in and out of the workforce, having children for example. What this will allow them to do is to salary sacrifice up to \$50,000 into an SMSF. However, there are still some unresolved issues about when the \$500,000 account balance limit is measured. Is it a 1 July calculation, anytime during the income year or a 30 June calculation?

The second announcement that will increase the amount of contributions that can be made to a SMSF is the extra 15% contribution that the Government will make, from 2013 where the individuals taxable income is less than \$37,000 pa.

The reason for this extra contribution is that individuals whose income is below \$37,000 have a marginal tax rate of 15% or less. In that case, they get no tax benefit out of contributing to an SMSF. Indeed, if their marginal tax rate is less than 15% then it is tax inefficient for them to contribute to a SMSF because any concessional contributions (redirected salary, say) is taxed in the SMSF at 15% (the contributions tax), which is equal to or greater than the marginal tax rate that they would have paid had they taken it as cash salary. So they would have been better off not contributing at all and using an after tax investment instead. Even more so when you consider that a 20 year old will not have access to their contributions for 40 years (unless they become disabled earlier) so a contribution can be locked up for up to 40 years. Investments outside a SMSF can be cashed at any time.

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In theoretical terms this is a vertical equity measure that ensures that low income earners get some tax advantage from using a SMSF and not all of the tax concessions from SMSFs go to the wealthy.

(Now I do not in any way want to sound conceited, but one of my Masters students pointed out to me recently that I had, in fact, suggested this extra contribution at a superannuation conference that I spoke at last year, at which were the Australian Treasury people who dream up these changes. Most probably I am wrong and that I had absolutely nothing to do with it but, given the salary that we get paid for this job, if I am wrong please don't tell me. Just let me believe that I have made a difference. It makes up for the crap pay.)

The third change that will increase contributions to SMSFs is the increase in the Superannuation Guarantee from 9% to 12% from 2020. Now there must be some doubt about this proceeding given the current state of the Government (at the date of writing). Broadly there is a cost to Government revenue when the superannuation guarantee is increased because income from employees that may have been taxed at the highest marginal tax rate will now be taxed at a flat 15% as a contribution to the fund. That loss in revenue to the Government was going to be made up by the increase in tax on mining companies and it is not certain (again at the date of writing) whether that mining tax will proceed.

Contribution strategies

This part of the paper lists 5 'vanilla' or traditional contribution strategies presently used in SMSFs:

Maximising concessional contributions,

Maximising non-concessional contributions,

Using Transition to retirement pensions to maximise contributions,

Using the small business CGT concession for contributions, and

Using the outcome of Ryan's case to maximise contributions.

Concessional contributions

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There is in fact no limit on the amount of deductible contributions that can be made by either an employer in respect of employees or by a substantially self-employed person – where the later is defined in terms of employment type income plus reportable fringe benefits plus, after 1 July 2009, certain sacrificed salary contributions being less than 10% of their total income. However, concessional contributions that exceed the concessional contributions limits are taxed at an extra 31.5%, in addition to the 15% contributions tax on the fund.

From 2009, the concessional contribution cap was reduced to \$25,000 pa and the transitional concessional contributions cap for those over age 50 until 2011-2012 reduced to \$50,000.³ As noted already, for people over age 50 whose account balance is less than \$500,000, they will get a \$50,000 cap from 2013.

The general rule is that concessional contributions are tax advantageous because:

They are taxed at 15% in the fund rather than the individual's Marginal Tax Rate (MTR), and

Earnings on those contributions are taxed at a nominal rate of 15% or, taking into account any imputation credits and sheltered capital gains, at an Effective Tax Rate (ETR) of between 6-8% instead of the individuals MTR had they invested outside a SMSF. (That ETR is the rate that Treasury uses in calculating the cost to the Revenue of superannuation concessions.)

Briefly, there are two strategies that are generally used to maximise concessional contributions:

The first is where a taxpayer is close to the 10% rule. In that case, crystallising tax preferred capital gains that are included in the denominator in the 10% rule to dilute 'employment related income' below 10% to get deductible contributions, and

Secondly, using taxable benefit components that are rebateable to increase the taxpayer's total assessable income to come within the 10% rule. In this case, if the taxpayer has reached the preservation age but is below age 60 and has not used any of their low-rate cap

² S 290-60 and 290-150 ITAA1997

³ S 292-20 ITAA 1997

amount already, they can be paid up to \$160,000 from an SMSF and that will be included in assessable income but will not be taxed because of an offsetting rebate, reducing the tax to zero.4

Maximising non-concessional contributions

Clearly the most important aspect of non-concessional contributions is what is called the 'bring forward' rule.⁵ In effect, this rule means that the nonconcessional limit is three times the otherwise applicable annual amount. So, instead of being limited to \$150,000 non-concessional contributions, a person can contribute up to \$450,000 over any three year period. Interestingly, this concession was meant to facilitate 'empty nesters' selling down the family home and using surplus proceeds to contribute to a superannuation fund.

Just two further comments about the 'bring forward 'rule:

First, it applies automatically. That is, once the annual non-concessional cap has been exceeded the taxpayer automatically can contribute up to \$450,000 of non-concessional contributions in that three year period, and

Secondly, it is only available to taxpayers who are 'under 65 years at any time' in the year that the non-concessional contributions cap is exceeded.6 So it is available to anyone who is age 64 on 1 July.

Within that context the standard strategy is to trigger the bring forward rule in the income year that the person turns 65 so that they can use it to contribute any large amounts (in excess of \$150,000) that they are likely to receive after the year that they turn 65. The benefit in doing this is that the earnings on the extra amount above the annual cap are held in a tax sheltered environment of a SMSF as soon as possible, rather than outside the SMSF where they would be taxed at their marginal tax rate while waiting to be contributed.

Transition to retirement

Where a taxpayer has reached their preservation age and triggered a cashing event it is possible for their SMSF to pay a pension, even though they continue to

⁴ S 301-20 ITAA 1997

⁴ S 301-20 11 AA 1997 ⁵ S292-85 (4) ITAA1997

⁶ S 292-85(2)(b) ITAA1997

work.⁷ The reason for this rule was to act as an incentive for people to remain in the workforce around retirement age instead of ceasing work and drawing on their superannuation accumulation, which was the other alternative.

The maximum pension that can now be taken has been restricted to 10% of the 1 July account balance. The tax benefits in using a Transition to Retirement pension are well understood as:

The income of the SMSF supporting the transition to retirement pension is tax free, a tax saving of a nominal 15%,

If the taxpayer is under age 60, they are entitled to a 15% rebate of the taxable part of the pension, and

For taxpayers over age 60, the pension is completely tax free.

Generally, transition to retirement pensions are used to replace otherwise fully assessable employment income that is taxed at the taxpayers' MTR with either rebateable or zero taxed pension income.

However, they do have another advantage and that is for converting the taxable component of a superannuation accumulation into a tax free component by the taxpayer recontributing the pension as a non-concessional contribution.

Just to put that in context, say a taxpayer age 57 has a 'partner' who comes within the definition of 'superannuation death dependant', which means that any lump sum benefit paid on death will be tax free as will any pension benefit if either the member is at least age 60 at death or the dependant is over age 60 at receipt. 8

However, that taxpayer also has two children who are over the age of 18, have no disabilities and otherwise do not come within the meaning of 'death benefit dependant'. In this later case, any taxable component of a death benefit will be taxable to those children. Using a Transition to Retirement pension to recontribute non-concessional contributions means that they will emerge tax free to those children on the taxpayer's death.

⁷ Reg. 1.06 SISR 1993

⁸ S302-60 ITAA1997

⁹ Subdiv. 302-C ITAA1997

Small Business CGT concession

In addition to the general non-concessional contribution limits available to all taxpayers, certain proceeds form the disposal of an 'active asset' up to \$1.155m, can be contributed to an SMSF without breaching the non-concessional contribution caps.¹⁰

There are in fact 4 small business CGT concessions generally referred to as:

15 retirement,

\$500,00 lifetime

50% concession, and

The rollover concession,

but it is important to note that only gains sheltered by the first two of those 4 come within the additional \$1.155m non-concessional contribution.¹¹

What that means is that taxpayers who, potentially, can shelter the gains using the first three concessions may be better off forgoing the third concession to maximise the amount that they can contribute. The benefit is simply that the best place to hold personal wealth is in a SMSF and that foregoing the third exemption maximises the amount in that can be contributed to the SMSF.

Ryan's case: Re Ryan and FCT (2004) 56 ATR 1122

The final strategy to discuss is that coming out of Ryan's case. Put simply, Ryan's case is authority for the proposition that tax deductible contributions can be made by an employer that are in excess of cash remuneration of the employee.

What that means, in effect, is that an employer can contribute to a SMSF for the benefit of an employee up to the concessional contribution caps regardless of the actual remuneration paid to the employee.

¹⁰ S292-100 ITAA1997

¹¹ Div 152 ITA A1997

Again, the tax savings are the difference between the employees MTR and the 15% tax paid in the fund, and the difference between their MTR on earnings on the contribution outside superannuation and an ETR of 6-8% on earnings in the fund.

However, using this strategy is not without cost because any sacrificed salary above the Superannuation Guarantee amount will be included as Reportable Employer Superannuation Contributions and is included in the income thresholds for the Government Co-contribution and the 10% employment income threshold in the deduction for substantially self employed contributions.

Leveraging the fund as a contribution strategy

The final strategy to discuss is the use of leverage in the fund as a means of getting value into an SMSF. This strategy relies on the 2007 changes that allow SMSFs to borrow to acquire an asset provided, amongst other things, that the lenders' rights are limited to the asset that the fund acquired. It also takes into account the announcement made by the Assistant Treasurer, Senator Nick Sherry, on 10 March that the CGT rules would be amended to ensure that the transfer of the asset on payment of the instalment amounts, where the asset is an 'exchange traded security in a company, trust or stapled entity' or asset acquired with a non-recourse loan would not create a CGT liability.¹²

Take a person who is an 'empty nester' who has just sold the family home and has \$1m left over after buying a smaller replacement residence.

In that case, they have two options:

First, contribute \$450,000 of the \$1m using the 'bring forward' rule and, after the three year period has expired, contribute another \$450,000 and so on. In that case, it will take seven years at a minimum before the full \$1m is in the fund,

Secondly, they could contribute \$450,000 using the 'bring forward' rule and lend the balance on a non-recourse basis for the fund to acquire an income producing asset. In the next three year period, forgo \$450,000 of

¹² Press release 037, http://assistant.treasurer.gov.au/. See Proposal Paper Income Tax of Instalment Warrants.

the non-recourse loan and in the next three year period forgo the balance of the loan.

Using that strategy, the fund gets the benefit of the increasing value of the asset acquired with the non-recourse loan and any gain on it when it is disposed of will be sheltered using the preferential tax rates of the fund.

A variation of this strategy is for the fund to acquire a 'business real property' asset from the member and leave the amount owing as a loan to the fund and forgo that loan progressively, as above.

ATO activity around contributions

The first thing to mention here are two changes that come out of the Global Financial Crisis (GFC). First, the ability for a SMSF to roll over any capital or revenue losses to another fund us to continue until June 2011. It should be noted that this concession is not available for loss transfers between two SMSFs. The fund receiving the loss transfers must have more than five members, which, necessarily, means that it cannot be a SMSF. Clearly this concession is directed at SMSFs that have these kinds of losses, rolling into, say, a public offer fund.

The second change that comes from the volatility caused by GFC and which will continue for another year is the 50% discount on the minimum payment that a SMSF must make for it to be treated as being in pension phase. Again, this concession recognises that SMSFs may have lost value as a result of the GFC and forcing them to pay the full annual payment when the equity markets were down seemed unreasonable.

Managing excess contributions

There are two issues around managing excess contributions.

First, the Government has announced that it will change the law so that the Commissioner can consider exercising the discretion that he has to reallocate excess contributions to another year or ignore the excess contribution altogether, even before he has made an excess contributions tax assessment.

A recent case highlighted this problem where a person who had exceeded the \$1M non concessional transition rules that applied up to July 2007 asked the

AAT to review the Commissioners' decision not to exercise that discretion. The AAT declined to do so on the basis that the discretion was not part of the assessment process for excess concessional contributions tax. (AAT Case [2010] AATA 573,Re McMennemin & Anor and FCT)

The ATO has issued several taxpayer alerts around contributions.

First, he has put taxpayers on notice that employee's nominating their SMSF to receive shares or options under employee share schemes for no consideration or below market value may be a contribution.

Secondly the Commissioner has issued a taxpayer alert about funds setting up special purpose trusts to hold contributions until it is certain that they do not breach the contribution caps for the member.

This alert was issued on and the points to make here is to outline the current state of play around this issue, which was considered at the NTLG meeting in late June 2010.

At a very high level it is hard to see what concern the Commissioner could have with these trusts. Broadly, the design of the system after 2007 is that the maximum amount of tax concessions that a person can get from a SMSF is limited through the contribution caps. That is the point of the contribution caps is to limit the amount of tax concessions that anyone can get from using a SMSF regardless of how wealthy they are you are the maximum tax breaks that you can get from a SMSF is limited by the amount of contributions, both pre tax and post tax, that go into the SMSF for your benfit. Before 2007 this role of limiting the amount of tax concessions was the role of Reasonable Benefit Limits.

Nevertheless, who whole point of the contribution caps is to limit the amount of tax concessions so one would have thought that any other mechanism, such as these special purpose trusts that hold contributions until it is certain that the contribution caps will not be exceeded, where consistent with that design. Isn't the point of ensuring that people do not exceed the contributions caps?

However, the Commissioner has raised a number of legal issues about their effectiveness, including whether amounts paid into them are contributions in any case and, also whether they satisfy the deduction rules for contributions.

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Some of the discussion in the NTLG minutes gives us some guidance about the real concerns that the Commissioner has with these arrangements and they are:

First, that SMSF that have been using these special purpose trusts have not been keeping the money separate from other parts of the fund, and

More importantly it is not clear who is liable for tax on the earnings on those amounts and at what rate those earnings would be taxed.

It seems that it might be some time before this issue is resolved.

Finally, there is a draft ruling on the table (SMSFD2010/D1) which considers when a benefit payment paid by cheque or promissory note is considered to be "cashed'. Clearly the concern here is that the money in the SMSF supporting any cheque or promissory note remain in the SMSF until the cheque or promissory note is presented and the funds cleared. An excessive delay confers a tax advantage on the SMSF as any earnings on the funds supporting the cheque or promissory note will get the tax rate applicable to the fund.

The draft says, in effect that a cheque or promissory note is considered to be 'cashed' if, on the objective purpose, the money is payable immediately (that is, not post dated) and the SMSF trustee has taken reasonable steps to ensure that the money is paid promptly.

Contributions and 'Reserves'

Just a couple of comments about the relationship between contributions and reserves in a fund.

As an integrity measure to support the contribution caps, all but three types of allocations to a member's account ("superannuation interest") are treated as 'contributions'. Without this integrity measure it would be possible to have 'internal contributions' (allocations from reserves) made to a member's account that would defeat the contribution caps.

After the clarification of what a 'contribution' to a SMSF is (in TR 2010/1) the ATO are now indicating that an allocation from a reserve is not a contribution for the purposes of the assessable contributions of an SMSF because they are not an 'addition to the capital of the fund', which is one of the criteria in TR 2010/1 of a contribution.

That also means that they are unlikely to be a non assessable contribution for the purposes of the 'proportioning rule', so would not come within the tax free component of a superannuation interest.

However, other than the three exceptions, an allocation is deemed to be a contribution solely for the purposes of the 'contribution' cap measures.

There are just two other comments to make about using reserves as a mechanism for contributing to a member's account.

First, the ATO has confirmed that allocation of reserves to a member of the fund, to the extent that they are treated as concessional contributions under Reg 292-25.01¹³, will be only counted against the member's contribution caps, when the amount is allocated and not when the amount is paid to the fund and credited to the reserve.

In that case, provide the 28 day period within which contributions must be allocated to member's accounts is satisfied, it is possible to make an otherwise excess contribution to the fund, which is held in a reserve and allocated in the next period for calculating the contribution cap for the member.¹⁴

¹³ Income Tax Assessment Regulations. S 292-25 (3) ITAA1997.

¹⁴ Reg 7.08 SIS Regs