

# Key Superannuation Issues for 2010

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**S**uperannuation remains the preferred investment vehicle for accumulating wealth for retirement. At the time of going to press, the Government's response to the Henry Taxation Review had been released while the response to the Cooper Review is still outstanding (Cooper's final report is due before 30 June 2010). Regardless of the recommendations and Government response from these reviews, any changes to superannuation contributions, investment restrictions or structure will need to receive bi-partisan support and may take some time to implement (all changes proposed as part of the Government's new tax initiative in response to the Henry Review will not commence implementation until at least 1 July 2012); therefore, maximising superannuation benefits for retirement remains relevant and strategic.

This paper will discuss some of the top issues and strategies to consider for superannuation in 2010.

## 1. CONTRIBUTIONS TO SUPERANNUATION – ISSUES TO CONSIDER

With the 50 per cent reduction in the Concessional Contribution (CC) caps, ensuring that clients do not exceed their caps is now more important than ever, and excess contributions to superannuation are likely to become more prevalent. With a potential 93 per cent tax rate on excess contributions, incorrectly managing contributions can be incredibly penalising if we are not taking the following issues into consideration.

### a. *The Limits are now Taxpayer-Based, rather than Contributor-Based*

This means that the onus is on the individual to get his/her contributions correct. Additionally, the mechanism to receive a refund of any excess Non-Concessional Contributions (NCCs) made to superannuation is only if a **single contribution by itself** is in excess of the cap. In these circumstances the trustee must return the excessive amount (not the entire contribution) to the contributor. If contributions are made to the fund over the course of the year, not taking into consideration contributions made in previous years or even those in the current year, this can result in excess tax being paid or jeopardising other contribution strategies.

### b. *Ensuring Bring-Forward Periods are Triggered appropriately*

The ability to make higher one-off contributions via the 'bring-forward' provisions was a positive change from the initial 2006 Budget announcements. However, if a client triggers a period accidentally it can have other consequences:

- A 'bring-forward' period is triggered when the taxpayer contributes any amount over his/her single year NCC cap. Accordingly, a contribution of \$150,001 would result in the taxpayer triggering a bring-forward period. This then limits him/her to \$450,000 of NCCs for the current and the following two financial years.
- If a taxpayer is unaware that he/she has triggered a bring-forward period in a particular year, he/she may seek to make a \$450,000 contribution in one of the ensuing financial years, which would result in an excess NCC.
- Triggering a bring-forward period as the taxpayer approaches age 65 can limit the level of contributions he/she can make to superannuation, as age 64 is the last time a member can make a \$450,000 contribution without having to meet the work test. Once age 65, the taxpayer is limited to \$150,000 per annum, and has to meet a work test for the fund to accept the contribution.
- Self-employed taxpayers are more likely to trigger bring-forward periods where they make contributions that are intended to be CCs, but are reclassified under the following circumstances:
  - The deduction they are claiming for the contribution would reduce their taxable income below nil.
  - They are ineligible to claim a deduction as they are unable to meet the 10 per cent test, which may become more common due to the inclusion of Reportable Employer Superannuation Contributions (RESA) in the calculation of the 10 per cent test (self-employed people can no longer salary sacrifice from any employment income to fall within the 10 per cent threshold).
  - The fund is unable to classify a contribution as a CC as it no longer holds the contribution. This occurs where the member has either rolled over his/her benefit to another fund, taken a lump sum withdrawal or commenced an income stream.
- Allocations from reserves may be classified as CCs if they are greater than 5 per cent of the member's account balance at the time of the allocation. This assessment toward the CC cap may result in excess CCs and subsequently either trigger a bring-forward period or become excess NCCs.
- Fully utilising a bring-forward amount in a particular financial year further prioritises the requirement that CCs are monitored closely. As excess CCs are assessed towards the NCC cap, if a taxpayer in these circumstances makes excess CCs over a bring-forward period, every excess CC will be subject to 93 per cent tax.

## CASE STUDY

In the 2007 calendar year, Monty (aged 61) wants to optimise his contributions to superannuation; accordingly, he takes advantage of the \$1M undeducted contribution leading up to 30 June 2007, as well as making a \$450,000 NCC in July 2007.

From 1 July 2007 through to 30 June 2010, Monty needs to ensure he does not exceed his CC cap. If he salary sacrifices:

- \$105,000 in 2007-08;
- \$104,000 in 2008-09; and
- \$62,000 in 2009-10 (considering that the penalty may only be 46.5 per cent, which is the same as his Marginal Tax Rate [MTR]), the excess tax payable would be as follows:

	CCs (\$)	Excess CC (\$)	Excess CC Tax (\$)	NCCs (\$)	Excess NCC (\$)	Excess NCC Tax (\$)
<b>2007-08</b>	105,000	5,000	1,575	450,000 NCC 5,000 X CC	5,000	2,325
<b>2008-09</b>	104,000	4,000	1,260	4,000 X CC	4,000	1,860
<b>2009-10</b>	62,000	12,000	3,780	12,000 X CC	12,000	5,580
<b>Total</b>		<b>21,000</b>	<b>6,615</b>			<b>9,765</b>

On total excess CCs of \$21,000, the excess tax payable is \$16,380, plus contributions tax of \$3,150, bringing total tax to \$19,530, or 93 per cent. This is clearly a disincentive for our clients, and the prime reason why they need to be aware of the consequences of excess contributions.

c. *What is a Contribution?*

With the finalisation of TR 2010/3, it is not just assets and cash that will be classified as contributions, but also certain other transactions: services provided to the fund or 'money's worth' transactions can now count. The ruling clarifies that anything that increases the capital of the fund where the **purpose** of that increase is to benefit one or more particular members of the fund will be classified as a contribution. Such transactions include:

- discretionary trust distributions (also captured under the non-arm's length income rules);
- paying expenses on behalf of the fund;
- forgiving any debt that the fund owes;
- if a guarantor does not exercise his/her right of indemnity against the fund, or that right did not exist in the first place, the payment by the guarantor to satisfy a debt of the fund will be a contribution to the fund; and
- the fund acquiring an asset from a related party and not receiving full consideration.

Other additions to the fund that would **not** be classified as contributions include:

- interest paid on a bank account;
- dividends paid on shares the fund owns;
- insurance proceeds paid to the fund upon the insurable event occurring; and
- where a commercial tenant improves its leased premises to provide a benefit to its business (not to the fund). This would need to be viewed on a case-by-case basis as, if the improvements are considered to be landlord fixtures, it may well be classified as a contribution.

This ruling also clarified the timing of contributions, which is very favorable with respect to the contribution of shares and property. The ruling clarifies that it is the change of beneficial ownership that is considered to be the time of the contribution, rather than the change of legal ownership. This was an issue with off-market share transfers, as legal ownership would change when the registry was updated and likewise with property transfers when the land titles office recognised the change. If all of the required paperwork is completed such that the transfer of ownership would be able to occur (the ownership is in transferrable form), then that is the date that the contribution is deemed to be made. If the forms are not fully completed, it is only upon completion that beneficial ownership would pass.

The timing of certain other transactions that are contributions is considered as follows:

- if cash is paid into the fund via electronic transfer or over the counter, it is the time the fund receives the amount that is the timing of the contribution;
- if a cheque is provided to the fund, it is the date the cheque is presented to the fund, unless it is dishonoured;
- if a post-dated cheque is presented to the fund, the contribution date is the later of the date on the cheque or the date the cheque is received, unless it is dishonoured; and
- if a discretionary trust resolves to make a distribution to a superannuation fund, the contribution is received by the fund at the time the trust resolves to make the distribution, not the time the distribution is made, as a right has been created when the trust makes the resolution.

One area requiring clarification that was not confirmed in the ruling was whether the wording of the trust deed could prevent the incidence of excess contributions. Some trust deeds are drafted such that the fund trustee is able to aggregate contributions for members over the course of the year, and if those total aggregated contributions exceed the relevant cap, any excess held would be deemed to be held in trust by the fund on behalf of the contributor and returned to the contributor. The Australian Taxation Office (ATO) released Taxpayer Alert 2010/2 to clarify its view, which is that such wording is ineffective, and any trustees who rely on the drafting and return contributions to the contributor in accordance with this wording may breach the contribution, preservation and payment standards.

A second area requiring confirmation is: what is a single contribution? This is important when considering contribution planning, as only a single contribution by itself that is excessive can be returned to the contributor pursuant to SISR 7.04. The main area of concern in this regard is the contribution of shares – will it be a parcel of shares, a portfolio of shares or a single share that is classified as a contribution? Under the Capital Gains Tax (CGT) provisions, each individual share is a separate CGT asset; however, a parcel of shares in a company can be transferred with one form. The clarification of this issue is very important for contribution planning with our clients.

## 2. CONTRIBUTIONS TO SUPERANNUATION – STRATEGIES AVAILABLE

There are some substantial restrictions on contributions to superannuation. However, as much as possible these should be optimised within the limits:

- The \$50,000 per annum pre-tax limit for taxpayers over age 50 ceases as at 30 June 2012 so should be taken advantage of where possible. However, as outlined in its response to the Henry Review, from 1 July 2012 the Government intends to allow workers aged over 50 with balances below \$500,000 to continue making up to \$50,000 in annual concessional super contributions.<sup>1</sup>
- The \$150,000 per annum after-tax limit should be utilised where possible, as it cannot be carried forward as:
  - surplus cash; and
  - in-specie share contributions – need to ensure any CGT is considered.
- Taxpayers under age 65 are able to 'bring-forward' two future years of after-tax contributions and contribute up to \$450,000.
- Where eligible, take advantage of the CGT cap, which can result in additional amounts of up to \$1,155,000 (in 2010-11) to be contributed to the fund.

## 3. SMSF BORROWING TO INVEST IN PROPERTY

The combination of low interest rates and reasonable rental yields has made borrowing to invest in property within superannuation an attractive strategy. The benefits are:

- income is generated in a tax-effective environment;
- capital growth is quarantined in a tax-effective or even tax-exempt structure;
- contributions to superannuation that can be used to make interest and principal repayments are concessional tax;
- borrowing can be from a bank or a related party (provided it is on commercial terms);

- capital in the fund can be leveraged to build wealth in a tax-effective environment;
- small business owners can utilise some of their super benefits to acquire business premises.

There are strict criteria which need to be met for a fund to borrow, including:

- the fund is only able to borrow to acquire a new asset, and is unable to borrow against existing fund assets;
- the fund only obtains beneficial ownership of the asset, with legal ownership able to be transferred upon the repayment of the loan;
- the fund is only able to borrow to acquire an asset that accords with the investment rules;
- the borrowing must be a limited recourse arrangement between the lender and the fund; and
- any borrowing between the fund and a related party should be on an arm's length basis.

These criteria should be considered prior to purchasing any asset, particularly prior to entering into a contract for sale. It is important to obtain specialist advice to ensure any borrowing arrangement not only meets the criteria but remains complying on an ongoing basis.

The Cooper Review's preliminary report into the operation of SMSFs considered the use of borrowing in superannuation. Their preliminary recommendation was that funds should continue to be able to borrow to invest; however, the borrowing should not be a core focus of the fund. The panel has proposed that this be reviewed in two years' time.<sup>2</sup>

## 4. ESTATE PLANNING AND SUPERANNUATION

Contrary to what many people believe, superannuation benefits are not governed by the deceased's Will. The Will only determines what happens to superannuation benefits when they are paid to the person's estate or legal personal representative. Accordingly, it is important to consider our clients' objectives with respect to both the payment of their superannuation benefits upon their passing, as well as the succession of their SMSF itself (where relevant):

1 Australian Government, Joint Media Release, Treasurer The Hon Wayne Swan MP and Minister for Superannuation The Hon Chris Bowen MP *STRONGER FAIRER SIMPLER - Superannuation banking the benefits of the boom*, <<http://mfsscl.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/027.htm&pageID=003&min=wms&Year=&DocType=>>, accessed 6 May 2010.

2 Australian Government, Super System Review Phase 3 Preliminary Report, *Self-Managed Super Solutions, Canberra*, 29 April 2010, <[http://www.supersystemreview.gov.au/content/downloads/self\\_managed\\_solutions/self\\_managed\\_super\\_solutions.pdf](http://www.supersystemreview.gov.au/content/downloads/self_managed_solutions/self_managed_super_solutions.pdf)>, accessed 5 May 2010.

- Would they like to be prescriptive as to who receives their superannuation benefits?
- Would they like to ensure the payment of their benefits are not subject to challenge?
- Would they like to optimise the tax effectiveness of their superannuation for their beneficiaries?
- Would they like their SMSF to continue on in perpetuity and benefit generations to come?
- How much control would they like to give their beneficiaries over their inheritance?
- How will the succession of the SMSF and payment of benefits affect other structures and our clients' overall estate planning objectives?

Reviewing the Estate Planning consequences of our clients' superannuation is imperative, and consideration needs to be given to who the ultimate beneficiaries are and the most effective means to pay out the benefits, the succession of a client's SMSF, and how the superannuation benefits fit with the other Estate Planning objectives.

## 5. RESERVING WITHIN AN SMSF

SMSFs are able to establish and maintain reserve accounts in the fund. These can be used for the following reasons:

- smooth investment returns;
- to pay fund expenses;
- to make pension payments;
- to self-insure against prescribed events;
- to pay out an additional benefit upon the passing of a member to obtain a substantial tax deduction for the fund;
- ensure bulky assets (such as property) do not need to be paid out of the fund upon a member passing; and
- to build up a fund that can continue on in perpetuity for future generations.

Reserves are a valuable tool for long-term family wealth accumulation. However, they need to be established and managed appropriately. It is important to note that if an amount is allocated from a reserve to a member's account, if that allocation is greater than 5 per cent of the member's account balance, the allocation will be classified as a CC.

## 6. TRANSFER OF BUSINESS PREMISES TO SUPER

Small business owners who own their premises via another structure could consider the transfer of their premises to superannuation. If adopting this strategy, the following factors should be taken into consideration:

- Business premises are usually exempt from the strict investment restrictions regarding acquiring assets from related parties, as they generally meet the definition of business real property. (As outlined in the Cooper Review preliminary report, business real property is intended to remain exempt from the restrictions imposed on the acquisition of assets by related parties and the in-house assets test).<sup>3</sup>
- The fund could borrow to acquire the premises.
- From a CGT perspective the entity that currently owns the premises may be eligible for small business concessions, managing any CGT on the transfer.
- If the small business CGT concessions are available, the member could use the CGT cap for part of the contribution, which enables a higher amount to be contributed to the fund.
- The transfer could be a part contribution, part purchase, part borrowing.
- An arm's length lease arrangement must be in place – the fund can thereby receive regular rental payments in a tax-effective structure.
- The transfer may be eligible for transfer duty exemption.
- There will be future growth of the asset in a tax-effective environment.

## CONCLUSION

With excess contributions likely to become more common, it is imperative that we are all aware of the issues with respect to contributions to superannuation, as well as make our clients aware of the implications if they exceed their limits. Once the funds are in the superannuation environment, optimising the investment opportunities is important, and considering the options available for our clients within the scope of the investment rules will assist in maximising their superannuation for retirement.

<sup>3</sup> Ibid.