Superannuation...

Where are we now?

On 1 July 2007, the Government introduced significant changes to simplify superannuation. The three main changes that have benefited our clients are:

1. Tax-free pensions for members aged over 60
2. Elimination of the Reasonable Benefit Limits
3. Greater flexibility as to how and when members can draw down their super

Since those changes were introduced, the government has continued to make on average one change every six months for the last seven years. This has created significant confusion amongst members as well as trustees of Self-Managed Superannuation Funds.

This Feature Article outlines some of the key changes and opportunities that affect our clients.

Contribution Caps

Concessional Contributions are generally those contributions that the contributor has claimed a tax deduction for, and forms part of the Super Fund's assessable income.

On 1 July 2013, the concessional contributions cap increased from $25,000 to $35,000 for individuals who are 59 years old or over on 30 June 2013. On 1 July 2014, the higher cap of $35,000 will also apply to people who are 49 years and over on 30 June 2014.

Non Concessional Contributions are generally the 'after-tax' contributions you make to a Super Fund and are not included in the Fund's assessable income.

The non-concessional contribution cap hasn't changed and continues to be $150,000 per annum. If you are under 65 years old, you can 'bring forward' two years' worth of contributions, giving you a total of $450,000 for the three years, rather than a $150,000 cap in each year of the three years. The three-year period automatically starts from the first year that you contribute more than that year's $150,000 non-concessional cap.

Extra 15% Contributions Tax for $300,000 plus Incomes!

From 1 July 2012, individuals earning above $300,000 must pay an additional 15% tax on their concessional contributions. Within approximately 6 months of the Individual's and Super Fund's returns being lodged, the ATO will determine whether your adjusted income has exceeded $300,000 and if so, send the individual a tax assessment for the additional 15% tax.

Once the individual receives the tax assessment, they will have three options:

- Pay the assessed tax
- Pay the assessed tax and then seek to be reimbursed from their Super Fund (must provide release authority); or
- Pass on the notice of assessment to the Super Fund (with a release authority) and for the Super Fund to pay the tax on behalf of the member.

Excess Concessional Contributions

Finally, there have been changes to the excess contributions tax system to make it fairer! Previously, if you inadvertently contributed more than the cap, the excess was taxed at a flat 46.5%, no matter your level of income.

From 1 July 2013, the excess above your concessional contribution cap will be treated as assessable income for the individual and taxed at your marginal rate of tax (plus an interest charge to account for the deferral of tax). For those individuals on less than the top marginal tax rate (ie. 38.5%, 34% or 20.5%), this will provide significant savings.

The excess contributions tax assessment is again assessed to the individual. Similar to the extra 15% tax on high income earners, the individual will need to provide a release authority for the tax to be paid by the Fund. However, the individual also has the option to have up to 85% of their excess concessional contributions released.

Taxing Pension Funds

Traditionally, when your member account transitions from accumulation phase to pension phase, the earnings generated from the assets supporting the pension become tax-free (compared to 15% tax when in accumulation phase).

From 1 July 2014, it is proposed that the earnings in excess of $100,000 per member will be subject to 15% tax. As capital gains form part of earnings, transitional measures will apply for assets purchased before 5 April 2013.

We would like to stress, that this is a proposed measure only, and because of the technical difficulties involved in introducing this additional tax we believe it may end up like the 'higher contribution cap for members with balances under $500K proposal' and be scrapped altogether.

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hoffmankelly CHARTERED ACCOUNTANTS

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Important changes for Business

- **Increase the super you pay:** The minimum amount of compulsory super you pay your employees has increased from 9% to 9.25% from 1 July 2013.
- **Pay super to employees over 70:** From 1 July 2013 you are now required to contribute super for employees who are aged over 70.
- **My Super:** Your default Super Fund will need to offer a MySuper account for employees who don't choose a fund. Small businesses have until 1 January 2014 to make this change.
- **Help for Small Business:** If you have 19 employees or fewer, the free Small Business Superannuation Clearing House can help you make all your super payments in one transaction.

tax tip:

Concessional contributions are still the number one tax planning tool!

Example:

John is a 60 year old engineer earning $160,000 per year and has $300,000 in Super. If John continues along as normal without considering his tax situation, he will have the following approximate tax liabilities for the 2014 financial year:

Tax on $160K Wage	$49,547
Tax on Super Earnings (Assuming earnings at 5% & tax at 15%)	$2,250
Total	**$51,797**

Alternatively, John received some tax and financial advice last June and decided to implement the following strategies.

1. **Salary Sacrifice an additional $20,000 into Superannuation.** John's 9.25% Compulsory Super was $14,800 ($160,000 * 9.25%), thereby increasing his total concessional contributions to $34,800 (under $35,000 concessional contribution cap).
2. **Commence a Transition to Retirement Income Stream (Pension)** on 1 July 2013 and take $12,300 as a tax-free pension being the equivalent 'after tax' amount to ensure John has the same personal cash flow.

Consequently, John now has the following approximate tax liabilities:

Tax on $140K Wage	$41,847
Tax on Super Earnings	$0
Tax on Additional Salary Sacrificed Super	$3,000
Total	**$44,847**

As a result, John has saved $6,950 in Tax! Assuming John continues with this strategy until he retires at the age of 65, he would have saved a total of $34,750.

New regime for punishing SMSF Trustees

Draft legislation has been designed to give the ATO more flexibility in dealing with breaches of the SIS Act by trustees of Self-Managed Super Funds. Currently, the ATO is restricted to issuing enforceable undertakings or the nuclear option of issuing a non-complying status which imposes a 46.5% tax on the assets of the fund (less tax-free component). These proposed new penalties will significantly extend the ATO's ability to deal with non-compliance by allowing the ATO to:

- Issue a rectification direction
- Issue an education direction
- Impose an administrative penalty of up to $10,200 for each breach personally payable by the offending trustee or director

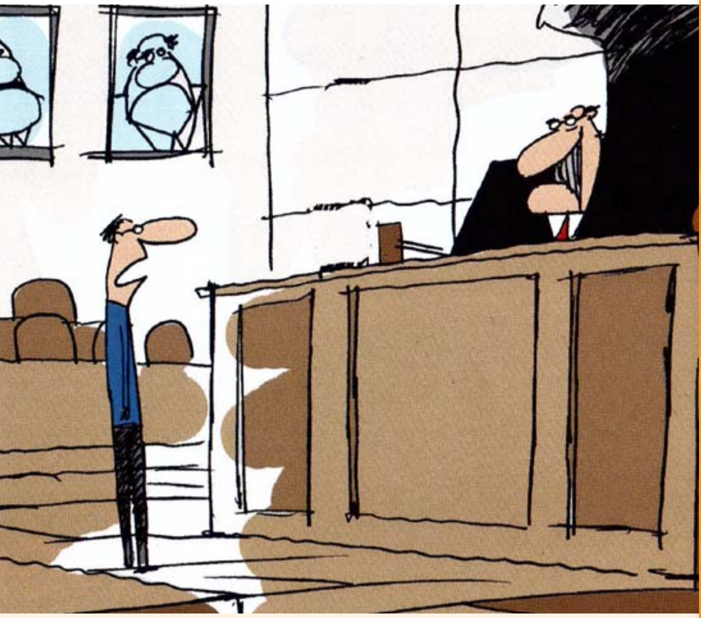
The following proposed administrative penalties will be mandatory and the penalty cannot be reimbursed out of the SMSF assets.

Section	Summary	Amount
34(1)	Compliance with Operation Standards	$3,400
35B	Accounts & records obligations	$1,700
65(1)	Prohibition on loans or financial assistance to related parties	$10,200
67(1)	Prohibition against borrowing	$10,200
84(1)	Breach of in-house assets	$10,200
103(1)	Duty to keep records/minutes for 10 years	$1,700
103(2)	Duty to keep records for 10 years	$1,700
104	Duty to keep records of change of trustee	$1,700
104A(2)	Trustee declaration requirements	$1,700
105(1)	Duty to keep reports	$1,700
106(1)	Duty to notify of significant adverse event	$10,200
106A(1)	Duty to notify of change in status	$3,400
124(1)	Written appointment of investment manager	$850
160(4)	Failure to comply with Education Direction	$850
254(1)	Give information required by approved form	$850
347A(5)	Obligation to participate in Statistics Program	$850

example:

Breaking the Rules...

A husband and wife learned the hard way about the importance of complying with the rules governing SMSFs. Between December 2004 and November 2007 they withdrew most of the fund for living expenses. Their accountant, who was also their tax agent and approved auditor, told them in September 2006 that he was obliged to report them to the ATO. The husband continued to withdraw money from the Super Fund. The withdrawals were treated as a loan to "associated persons" however, there was no written loan agreement and it was determined by the ATO the whole of the amount constituted illegal early access to preserved super benefits. In addition to the tax and penalties imposed on the withdrawals, the court found the husband guilty and imposed a sentence of six months imprisonment.



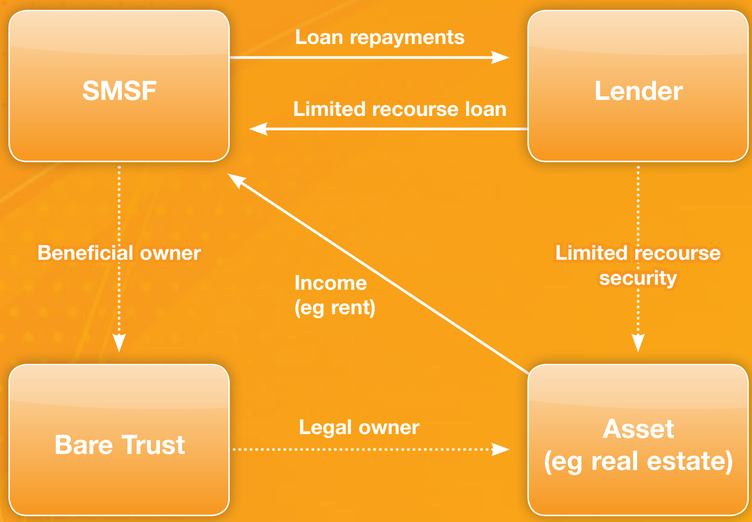
"How can it be tax evasion when they caught me?"

SMSF Fun Facts

- There are over 510,000 SMSFs
- 35,776 new SMSF were setup last financial year
- SMSFs average asset allocation includes 31% Direct Listed Shares, 30% Cash, 12% Commercial Property and 3% Residential Property
- Median assets per SMSF is $518,428
- Some SMSF have assets over $100 million

Superannuation...

Limited Recourse Borrowing Arrangements (LRBA)



Since the inception of superannuation, a key feature has been the general prohibition against borrowing by a Super Fund. However, in September 2007 specific provisions were introduced that allow SMSFs to borrow from a third party (bank) or related party (members) to purchase a single asset (normally a residential or commercial property) that is held in a bare trust.

The SMSF acquires a beneficial interest in the asset with the bare trust being the owner of the asset. All income and gains from the investment are received by the fund. The lender only has security against the asset in the bare trust, thereby protecting the other assets of the fund ('limited recourse loan').

Whilst the diagram may look complicated, the bare trust effectively exists on paper. It does not have a bank account and is not required to lodge an income tax return. All income (eg. rent) and expenses relating to the investment transact through the SMSF bank account and are reported in the fund's financials and tax return.

KEY BENEFITS

- **Leverage your superannuation savings:** An SMSF limited recourse arrangement allows your SMSF to borrow for investment purposes.
- **Tax Concessions:** Investment income and capital gains received from the investment are taxed at the concessional superannuation rates (generally 10-15%). If the SMSF is in 'pension phase' the tax could be nil. Therefore, significant capital gains accrued over many years can be completely tax-free if the SMSF is in pension phase at the time of sale.
- **Asset Protection:** Generally, superannuation assets are protected against creditors in the event of bankruptcy.

KEY RISKS

- **Only certain assets can be acquired:** SMSFs are restricted to the type of assets they can purchase and from whom they are purchased from (eg. related parties). These same rules apply under limited recourse borrowing arrangements.
- **Property Improvements:** Assets acquired under an LRBA have various restrictions, including a prohibition on fundamentally changing the asset's character. However, SMSF money can be used to improve the asset provided they don't change the character. For instance, an SMSF could renovate an LRBA property's kitchen, but could not build a house on an LRBA vacant land asset.

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Superannuation LRBA *continued*

- **Funding Improvements:** Assets subject to an LRBA have restrictions on borrowing funds to improve the asset, although borrowing may be used to repair / maintain an asset. The difference between improvement, maintenance and repair is often subtle. To carry out improvements, a fund's own cash must be used, and must not be to such an extent as to change the underlying character of the asset.
- **Costs:** There are additional costs in establishing the structure including setup fees for the new separate trust and company to act as trustee. In addition, banks usually charge additional fees for vetting the fund's trust deed.
- **Liquidity:** Loan repayments are generally required to be deducted from the SMSF. That means your fund must always have sufficient liquidity to meet the loan repayments.

Hoffman Kelly client with LRBA and no-interest related party loan – ATO Private Ruling approved!

In February 2013, Hoffman Kelly received an ATO Private Ruling on behalf of a client which approved the ability of the members to lend to their SMSF using a limited recourse borrowing arrangement at 0% interest!

In this situation, the members lent $3 million to their SMSF to purchase a commercial property. The loan was for a period of 15 years with an original interest rate of RBA Cash Rate plus 3% (approximately $180K interest per annum). The loan was varied to 0% interest to enable the SMSF to repay the principal within a shorter time and to help the fund meet its future minimum pension payment increases. The ATO approved the 0% loan, confirming there was no breach of the super or tax rules.

As a result of the 0% interest, the members now have approximately $54K less tax per annum. In addition, structuring the commercial property purchase using an LRBA within their SMSF will significantly reduce or eliminate future tax on the earnings and capital gains from the investment.

example:

Small business restructures commercial property within SMSF

BACKGROUND:

- Jim and Sue are both > 55yrs of age (Jim is 60 years, Sue is 59 years).
- They have $300K (combined) in industry superannuation.
- They run a small business which has a net taxable profit of $100K (and no other taxable income).
- They own the commercial premises in which the business is operated which has a market value of $500K.
- They own a house worth $1 Million with a private mortgage (non tax-deductible) of $500K.
- Although still working they can commence a 'Transition to Retirement Income Stream' (Pension). At that point their superannuation account enters 'Pension Phase' and all earnings and capital gains are completely exempt from tax.

Jim and Sue set up an SMSF, roll their existing industry superannuation ($300K) into the SMSF, and borrow a further $220K (tax deductible interest within the SMSF) to cover the balance of the purchase price plus stamp duty/incidentals.

Their SMSF could purchases the business premises, with the $500k sale proceeds used by Jim and Sue to pay out their private mortgage completely. (Note. Capital gains tax exempt due to the application of small business CGT concessions).

Annual rent of $50k (10% yield) is paid to the fund. This rent is tax deductible to the business, but is exempt from tax in the superannuation fund.

The balance of taxable income is now only $25K each. If they contribute $7K each of this into superannuation their personal income will be below the Tax Free Threshold and they will pay no tax whatsoever.

Therefore, after the restructure, tax paid on the entire $100K profit is effectively just $2K (15% contributions tax in the fund on $14K contributed). Without the restructure the tax expenses was $16.200.

NOTE:

- The TTR pension taken from superannuation to compensate for the contributions made into the fund is tax-free to Jim.
- No CGT is payable when the commercial premises are ultimately sold in Pension Phase.

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