Strategies to put a positive spin on negative returns

SPEAKER

Mary Simmons

TITLE

Technical Manager

ORGANISATION

SMSF Association

Strategies to put a positive spin on negative returns

Overview

Despite well formulated investment strategies and appropriate investment advice, no trustee could have foreseen the impacts of COVID-19 on financial markets globally. For SMSFs that have experienced some negative returns, there may be an opportunity to ensure member benefits are restored in the most tax effective manner. Particularly if members are approaching retirement and do not have the luxury to wait for markets to recover.

This paper discusses members' superannuation interest(s) in an SMSF and highlights a trustee's responsibility to track the preservation status of a member's benefit as well as the taxation components of each separate interest. The paper explains the application of the proportioning rule to ensure that when a superannuation benefit is paid as either a lump sum or as a pension, the trustee knows how to split the benefit between the tax-free and taxable components.

If a member has an accumulation interest, their tax-free component is based on a prescribed formula. All residual benefits, including all investment earnings, then make up their taxable component. In an environment of negative returns, the member's taxable component is reduced until it is exhausted before notionally reducing the tax-free component.

Where the value of a member's account falls so that it is less than the member's prescribed tax-free component, any notional or temporary reduction in the dollar value of the member's tax-free component can be recouped. This presents an opportunity to reclassify what would ordinarily be treated as taxable component as tax-free. For example:

- Investment earnings can be treated as a tax-free component.
- The net amount of concessional contributions made based on the annual cap and any unused carried forward cap can be treated as tax-free component.

- Any taxable benefits rolled over by a member from another super provider can be reclassified as tax-free component.

Once a member's prescribed tax-free component is restored, the trustee must revert to treating the above-mentioned amounts, as part of a member's taxable component.

Get the timing right and a member may even be able to essentially 'lock-in' the components of a pension with a high tax-free component, ensuring that all future earnings are classified as tax-free component. This includes starting a transition to retirement income stream.

However, get the wrong advice and rollover a member's benefit before any notional reduction in a member's tax-free component has been restored and the proportioning rule will be triggered, permanently reducing the member's tax-free component.

Minimum Benefits

The trustee of an SMSF must maintain minimum benefits for all members and retain these minimum benefits in the fund until they are cashed, rolled over, or transferred accordingly.

In plain terms, a member's 'minimum benefits' in an accumulation account are made up of all contributions and rollovers received for the member plus any earnings attributable to the member less tax and fees.

Every amount or entitlement that a member holds in an SMSF is to be treated by the trustee as a single superannuation interest[1] except when a new pension starts.

Each time a new pension starts, the amount supporting that pension must be treated as a separate interest. This means that each member can have multiple interests in an SMSF but is limited to only one accumulation interest in an SMSF.

Trustees have the responsibility to track two elements within each member's superannuation interest:

[1] Reg 307-200.02 Income Tax Assessment Regulations 1997

- preservation status
- taxation components

Preservation Status

The classification into the various preservation components depends on the source and date of a member's contributions and whether the member has satisfied a condition of release[2].

The three types of preservation categories that can make up members' superannuation benefits are:

1. **Preserved benefits:** All contributions made to a fund as well as earnings on them since 1 July 1999. Upon satisfying a condition of release, a member's benefit may still be subject to 'cashing restrictions' which specify how much and in what form a benefit can be accessed.
2. **Restricted non-preserved benefits:** A special category of preserved benefits calculated and crystallised at 1 July 1999 which cannot be increased after that date unless a rollover is received by the SMSF that contains restricted non-preserved benefits. The conditions of release and cashing restrictions are the same as those for preserved benefits but with an additional condition of release being 'termination of gainful employment' with an employer who contributed to the fund.
3. **Unrestricted non-preserved benefits:** Subject to the super fund's deed, these are benefits that can be withdrawn at any time, as a member has met a condition of release with a nil cashing restriction.

Essentially, with the preservation rules changing from 1 July 1999, *all contributions and all earnings* in a fund from this date, are preserved benefits reduced by any amounts of restricted non-preserved or unrestricted non-preserved benefits.

[2] Schedule 1, Superannuation Industry (Supervision) Regulations 1994

If a condition of release is satisfied and no cashing restrictions apply, the value of the member's interest at that point in time will be classified as unrestricted non-preserved benefits. These benefits can then be accessed by the member at any stage.

All further contributions or earnings added to that member's interest will be preserved benefits and a further condition of release will need to be met to access these amounts, even if it is a reconfirmation of an existing condition i.e. still retired with no intention of working again.

There are two exceptions to this rule:

- earnings added to a pension interest commenced under a condition of release with a nil cashing restriction are not preserved benefits (excludes transition to retirement pensions not in retirement phase); and
- once a member turns 65, all future earnings are unrestricted non-preserved benefits.

The table below summarises the most common transactions in an SMSF and the operation of the preservation rules.

	PBs	UNPBs
CONTRIBUTIONS (AT THE TIME THE CONTRIBUTION IS MADE)		
Aged < 65	✓	
65 or over at the time the contribution is made		✓
EARNINGS		
Accumulation phase & aged < 65	✓	
Accumulation phase & 65 or over		✓
TRIS (not in retirement phase)	✓	
Income stream in retirement phase (including TRIS)		✓

Negative Returns

When a fund experiences negative returns, the losses are debited from a member’s interest in the following order:

1. from the member's preserved benefits
2. from the member's restricted non-preserved benefits

3. from the member's unrestricted non-preserved benefits.

This means that any subsequent positive investment returns, cannot restore a member's restricted non-preserved benefits or unrestricted non-preserved benefits, to their original levels which were reduced due to negative returns. This is simply because all investment returns from 1 July 1999 are preserved subject to the two exceptions mentioned above.

Example 1 – Preserved benefits & Negative returns
Sal's superannuation balance is \$450,000, which is made up of \$70,000 preserved benefits and \$380,000 unrestricted non-preserved benefits. At the end of the financial year, the balance has been reduced to \$360,000 due to poor investment decisions. The \$90,000 loss is first deducted from the preserved benefits until that is exhausted and then from the unrestricted non-preserved benefits. The unrestricted non-preserved benefits will therefore be reduced to \$360,000. If at the end of the next financial year, her member balance increases to \$400,000 due to positive market returns, the earnings will be classified as preserved benefits. Therefore, Sal's benefits will be classified as \$360,000 unrestricted non-preserved benefits and \$40,000 preserved benefits.

Taxable components

Each member's superannuation interest in an SMSF will have two components:

- the tax-free component
- the taxable component

Tax-free component

The tax-free component of a superannuation interest is the amount consisting of the:

- 'contributions segment'
- 'crystallised segment'

The tax-free component is a fixed-dollar amount that is not affected by fund earnings in an accumulation interest. It can only be changed by adding more contributions or making lump sum withdrawals.

Tax-free component — contribution segment

The 'contributions segment' consists of all contributions made from 1 July 2007 that have not been included in the assessable income of the fund.

These contributions can include non-concessional contributions, downsizer contributions, personal injury contributions, government co-contributions, and eligible small business capital gains tax contributions.

Any tax-free component of an amount rolled over from another superannuation fund is also included in this amount.

Tax-free component — crystallised segment

The 'crystallised segment' of a superannuation interest relates to benefits that existed before 1 July 2007. It includes the value at 30 June 2007 of the:

- concessional component
- post-June 1994 invalidity component
- undeducted contributions
- capital gains tax-exempt component
- pre-July 1983 component.

On 1 July 2007, SMSF trustees were required to calculate the crystallised segment for all accumulation interests held by a member at 30 June 2007. Similarly, all pension interests that were commenced prior to 30 June 2007 and paid to a member aged 60 or over had their crystallised segment calculated based on their value at 30 June 2007.

Pensions commenced prior to 30 June 2007 being paid to a member aged below 60 did not require a crystallised segment to be calculated until a 'trigger event' occurs.

Trigger events for pensioners under the age of 60 are:

- turning 60
- taking a partial and full commutation (lump sum payment)
- death.

On satisfying one of these events the members' benefit needed to be crystallized at that time. Until that point, a member's tax-free component will be based on pre-2007 deductible amount rules. With the exception of disability superannuation income streams and death benefit income streams, these pensions are not very common.

Taxable components

The taxable component of a superannuation interest is the total value of the member's interest less the tax-free component. Employer and deductible personal contributions are included in the taxable component.

The taxable component can contain a taxed and an untaxed element. The taxed element includes amounts the SMSF has paid 15% tax on. The untaxed element includes amounts where a fund has not paid any tax on the contributions or earnings and typically higher rates of tax will apply to this component.

In an SMSF it is uncommon to have an untaxed element unless paying a lump sum death benefit to a non death benefit dependant[3] (commonly referred to as a 'tax dependant') that includes insurance proceeds for which the SMSF claimed a tax deduction for the premiums.

An SMSF trustee will not need to calculate an untaxed element in the following circumstances:

- Where a death benefit is paid as a pension, even if the pension includes insurance proceeds for which the trustee has claimed a deduction, as an untaxed element does not arise.
- Where the deceased was aged 65 or over when they died, as an untaxed element does not arise.
- Where a lump sum death benefit is paid to a tax dependant, it is non-assessable non-exempt income regardless of the underlying tax components.

[3] Section 302-195 Income Tax Assessment Act 1997

Negative Earnings

In a pension, earnings are proportioned across the tax-free and taxable components as per the proportions determined when the pension starts. That is, the proportions are calculated when the pension starts and are not recalculated during the life of that pension. Therefore, the percentage of the tax-free and taxable components in the pension phase will not be affected by negative earnings.

In an accumulation interest, the components are not static with all fund earnings attributable to the taxable component. By the same token, any negative returns will reduce a member's taxable component until it is exhausted before notionally reducing any tax-free component.

Where the value of an accumulation account falls so that its value is less than the prescribed tax-free amount, the tax-free component may be permanently reduced once the proportioning rule is triggered or the money is rolled to a new superannuation fund.

However, where the proportioning rule is not triggered, any temporary reduction in the dollar value of the tax-free component can be recouped.

Example 2 – Taxation Components and Negative Earnings
Con's member balance included a rollover of $75,000 (taxable component) plus $300,000 of non-concessional contributions and a CGT small business retirement contribution of $200,000, totaling $575,000. He has not contributed since. Due to bad investment decisions, his member balance is now valued at $460,000. If Con winds-up his SMSF and rolls over his entire benefit of $460,000 into an APRA regulated fund, he would trigger the proportioning rule. Con's tax-free component in the new fund would be locked in at the lower amount of $460,000. Unless he makes additional non-concessional contributions, his tax-free component will be fixed at $460,000, despite any positive earnings. Alternatively, if Con retains his SMSF, the prescribed tax-free component remains at $500,000 despite his balance dropping to $460,000. Whilst Con's member balance remains less than his tax-free component of $500,000, he has a few options available to him to restore his tax-free component:

1. Simply wait - All future investment earnings will form part of his tax-free component until the account balance recovers to $500,000.

2. Consider eligibility to make concessional contributions - If Con makes a concessional contribution of $25,000 the net amount of $21,250 (allowing for contributions tax of $3,750) would be added to his super account. Con's concessional contribution will be reclassified from being taxable to tax-free component.

3. Consider a rollover from another super fund - If Con rolls over $100,000 of taxable benefits from another fund to his SMSF, his new member balance would be $560,000 and consist of $500,000 of tax-free and $60,000 of taxable components. In effect, $40,000 of the taxable component of his rolled over benefit can be converted into tax-free component.

Proportioning superannuation benefits

When a superannuation benefit is paid out of an SMSF, the benefit needs to be split between a member's tax-free component and taxable component using the proportioning rule.

A member is not able to select their tax components. The split between the tax-free and taxable components for a superannuation benefit is calculated by:

- determining the proportions of the "value of the superannuation interest" those components represent, and
- applying those proportions to the benefit paid out.

Therefore, a superannuation benefit is taken to include the tax-free and taxable components in the same proportions that the components make up of the total value of the superannuation interest.

The value of a superannuation interest and the triggering of the proportioning rule to determine the tax components occurs each time:

- a lump sum benefit is paid from an accumulation interest; or

- a pension starts, regardless of whether or not it is in retirement phase.

Example 3– Lump Sum Proportioning

Con has an accumulation interest valued at $575,000 which comprised of $75,000 taxable component and $500,000 tax-free component. The proportioning split is determined as a percentage of the total interest which is 13% taxable component and 87% tax-free component.

If Con takes a lump sum benefit of $50,000 the split will be $6,500 taxable component (13%) and $43,500 tax-free component (87%).

12 months later Con takes another lump sum of $100,000. At the time, his interest is valued at $450,000. As the value of his accumulation account is less than his remaining prescribed tax-free amount (i.e. $500,000- $43,500) the lump sum will be 100% tax-free component. Triggering the proportioning rule when the lump sum is paid, will see his tax-free component permanently reduce by $100,000.

As mentioned earlier, when commencing a pension, the SMSF trustee must create a new superannuation interest. At the establishment of this new interest, the trustee must apply the proportioning rule to work out the tax-free and taxable components of the pension.

All benefits subsequently taken from the pension interest will be taxed based on the same proportion, which does not change. This applies to all pension payments as well as lump sum commutations from that pension interest, for the life of the pension.

The proportions also continue to apply should the pension automatically revert to a dependant upon the death of the original pensioner.

In the case of a non-reversionary pension that was payable to a deceased member prior to their death the tax-free and taxable proportions will generally continue on the same basis as the original pension until the benefit is ‘cashed’.

Example 4 – Income Stream Proportioning
Assuming that Con does not take a lump sum but rather commences an account-based pension using his entire balance. The split for the pension will be calculated as $500,000 tax-free component (87%) and $75,000 taxable component (13%). This split applies to every pension payment and any lump sum withdrawal made from that pension interest. All earnings (positive or negative) in the pension interest will be split between the tax-free and taxable components according to the proportions set at commencement.

Proportioning rule modifications

Listed below are some of the instances where the proportioning rule does not apply or is modified:

- A superannuation guarantee payment which consists entirely of taxable component (s307-130 ITAA 1997)
- A superannuation co-contribution benefit payment which consists entirely of a tax-free component (s307-135 ITAA 1997)
- A contributions splitting superannuation benefit which consists entirely of a taxable component (s307-140 ITAA 1997)
- A lump sum disability superannuation benefit which increases the tax-free component under a formula (s307-145 ITAA 1997)
- Excess contributions paid under a release authority are non-assessable non-exempt income and exempt from the proportioning rule (s303-15 ITAA 1997)
- A lump sum super benefit that contains an untaxed element (s307-150 ITAA 1997)

<u>Death and Insurance proceeds</u>

TR 2010/1 Income Tax: superannuation contributions confirms that any insurance proceeds received by an SMSF trustee "*... will be treated as income, profit or gain* *from the use of the fund's existing capital*". This means that by default, insurance proceeds are treated as part of the investment return of an SMSF.

Therefore, where life insurance proceeds are allocated to a deceased member's accumulation account, they will form part of the deceased member's taxable component and the ordinary proportioning rules would apply.

In the case of a reversionary pension, insurance proceeds are added to that pension interest based on the proportions as determined when the original pension commenced. Any subsequent lump sum from the reversionary pension, including on the death of the reversionary pensioner, will retain the same split between tax-free and taxable components.

In the case of a non-reversionary superannuation income stream that is payable to a dependant on the death of a member, the tax-free and taxable proportions will continue on the same basis as the original pension interest, until the death benefit is 'cashed'. That is, investment earnings continue to be apportioned between the tax-free and taxable components. However, the proportioning rules are modified to ensure that any insurance related amounts added to the deceased member's pension balance after death are treated as 100% taxable component[4]. In some instances, the taxed component may contain an untaxed element.

Example 5 – Non-reversionary Income Stream Proportioning
Sal was receiving a pension which was non-reversionary at the time of her death. The split of tax-free and taxable component was 70%:30%. At the time of Sal's death, the balance of her pension was $450,000. In addition, the proceeds of an insurance policy of $300,000 were added to the pension interest. Sal has a valid binding death benefit nomination to pay a pension to her disabled child Kevin. The tax-free component is modified as follows: = (death benefit – increase after death) x original tax-free proportion

[4] Reg 307-125(2) Income Tax Assessment Regulations 1997

= ($750,000 - $300,000) x 70% = $315,000

The taxable component is then determined as follows:

= Value of death benefit - tax-free component

= $750,000 - $315,000 = $435,000

The proportions of Kevin's death benefit pension would be locked in as 42% tax-free component and 58% taxable component.

Example 6– Non-reversionary Income Stream Proportioning

Following on from Example 5, let's assume that before Sal's death benefit is paid as a non reversionary pension to Kevin, the SMSF experiences a 20% drop in value. Sal's pension balance is now worth $360,000 plus insurance proceeds of $300,000.

The proportions of the non reversionary pension to Kevin are set out below:

Non-Reversionary Pension			**Totals**
Proportions set at start of pension	Tax-free (70%)	Taxable (30%)	
	$315,000	$135,000	$450,000
Negative returns	($63,000)	($27,000)	($90,000)
Modified proportioning rule		$300,000	$300,000
Non reversionary pension proportions	$252,000	$408,000	$660,000
	38%	**62%**	

The tax-free component is modified as follows:

= (death benefit – increase after death) x original tax-free proportion

= ($660,000 - $300,000) x 70% = $252,000

The taxable component is then determined as follows:

= Value of death benefit - tax-free component

= $660,000 - $252,000 = $408,000

Disability payment

To meet the requirements under the tax laws to treat an amount as a disability superannuation benefit[5] an SMSF trustee requires certification from 2 medical practitioners that the member is unlikely to engage in future employment due to their condition. A disability superannuation benefit may be paid as either an income stream benefit or a lump sum benefit.

Where a lump-sum disability payment is made, it will be taxed like an ordinary lump sum superannuation benefit, but the proportioning rules are modified to allow for a higher tax-free component. In essence, the tax-free component of the benefit is increased to reflect the period where the member could have expected to be gainfully employed if the disability had not occurred[6]. The tax-free component cannot exceed the amount of the benefit. The taxable component is calculated by subtracting the total tax-free component from the total amount of the lump sum.

The tax-free component is not modified where the member commences a disability pension with the same fund (ATOID 2009/125.) However, a disability super benefit that is rolled over to a new SMSF to commence a disability pension will constitute a payment and qualify for the increased tax-free component.

Conclusion

Monitoring the preservation status of a member's superannuation benefits is important, particularly in an environment of negative returns which can permanently reduce a member's unrestricted non-preserved benefits.

In an environment of negative returns, it is also important to understand the operation of the proportioning rules as an opportunity may present to reclassify what would ordinarily be treated as taxable component as tax-free until any notional reduction in a member's tax-free component is restored.

As a general rule of thumb, where it is expected that the SMSF's assets may decline in value, consideration could be given to starting a pension later rather than sooner. This

[5] Section 995-1(1) of the Income Tax Assessment Act 1997
[6] Section 307-145 Income Tax Assessment Act 1997

approach has the potential to allow any reduction in asset values to erode the taxable component and maximise the tax-free component.

Alternatively, where it is expected that the SMSF's assets are likely to increase in value, commencing a pension sooner rather than later can potentially maximise a member's tax-free component and ensure that any growth thereafter is proportionate.