# SMSF Pensions II
# Re-contributions and other strategies

## August 2015

# Agenda

- The meaning of a superannuation interest
- The Contributions segment
- The Crystallised segment
- Superannuation interests and modifications to tax components
- Re-contributions and other pension strategies
- How can we help?

# Superannuation interests

- It is important to understand the key concepts before starting a pension in an SMSF.
- These include:
  - Superannuation interests
  - Tax components
  - Proportioning
- Once these are understood one can then consider strategies to optimise income stream benefits.

# Superannuation interests

- The concept of a superannuation interest is important.
- It is crucial in understanding the calculation of the tax components of a superannuation benefit.
- The proportioning rules are covered in s307-125 of the ITAA (1997).
- It outlines how the tax free and taxable component are calculated.

# Superannuation interests

- They are calculated by:
  - Determining the proportions of the tax free and taxable component included in the value of the member's superannuation interest from which the benefit is taken
  - Applying those proportions to the benefit being taken.
- Therefore the tax components of the benefit payment will generally inherit the tax components of the superannuation interest from which it is drawn.

# Superannuation interests

**Meaning of a superannuation interest**

- Under Reg 307-200.02 of the ITAR (1997) a superannuation benefit in an SMSF is defined as:
  - The combined value of every amount, benefit or entitlement that a member holds in the fund at that time.
- Therefore under the proportioning rules, a member will only ever have one accumulation interest in an SMSF.
- *However under Reg 307-200.05 of the ITAR (1997) an amount that supports an income stream will always be a separate superannuation interest.*

# Superannuation interests

**Meaning of a superannuation interest**

- Therefore where a member uses part of their accumulation balance to start and income stream, *they would have multiple superannuation interests in the one fund.*

- *Those interests would be treated separately for the purposes of the proportioning rules.*

- The amount in accumulation would be one superannuation interest.

- The pension (or pensions) would be separate superannuation interests.

# Superannuation interests

**Case Study – three superannuation interests**

- Richard has an accumulation benefit in his SMSF plus two different account based pensions.

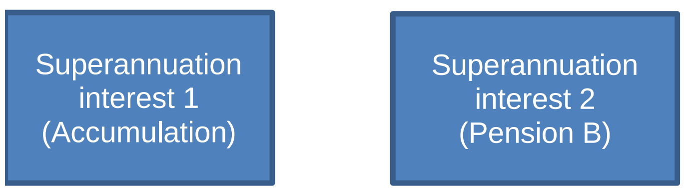
- In this case, Richard would have three separate superannuation interests:

| Superannuation interest 1 (Accumulation) | Superannuation interest 2 (Pension A) | Superannuation interest 3 (Pension B) |
|---|---|---|

# Superannuation interests

**Case Study – three superannuation interests**

- Let’s say Richard decides to commute Pension A and roll it back into the accumulation interest.
- When an income stream is commuted back to form part of a member’s accumulation interest it will be merged with the existing accumulation interest.



# Superannuation interests

**Case Study – three superannuation interests**

- The existing accumulation interest was $500,000 all taxable.
- Pension A was worth $500,000 100% tax free.
- Pension B was worth $500,000 100% taxable.
- Therefore if Pension A is commuted, the accumulation account will be $1,000,000 – 50% tax free and 50% taxable.

# Superannuation interests

**When a superannuation interest is valued**

- When determining the tax components of a benefit the value of a superannuation interest is as follows:
  - Where the benefit is a lump sum paid from a superannuation interest in accumulation phase – just prior to the benefit being paid.
  - Where the benefit is a payment from a superannuation income stream (including commutation) – when the income stream commenced.

# Superannuation interests

**Example – benefit paid from accumulation interest**

- Barry takes a $10,000 benefit from a superannuation interest of $100,000.
- It consists of 30% tax free and 70% taxable.
- Therefore $3,000 of the benefit taken is tax free (30%).
- $7,000 is taxable (70%).

# Superannuation interests

**Example – benefit paid from an income stream**

- Ray uses $500,000 to purchase an account based pension on 1 July 2012.
- The superannuation interest consists of the following tax components just prior to commencement:
  - Tax free $300,000 (60%)
  - Taxable $200,000 (40%)
- The tax components of the superannuation interest apply to all pension payments (60/40).

# Superannuation interests

**Example – benefit paid from an income stream**

- Therefore if $30,000 in pension payments are taken from the fund, the split between tax free and taxable is as follows:

    - Tax free $18,000 (60%)
    - Taxable $12,000 (40%)

- If a partial lump sum commutation of $50,000 is taken from the fund, the components are as follows:

    - Tax free $30,000 (60%)
    - Taxable $20,000 (40%)

- *This applies regardless of the change in value of the pension over time.*

# The Contributions segment

**Calculation of components**

- Calculated under s307-210 and s307-215 of the ITAA (1997).
- Tax free component is calculated as follows:
  - *Contributions segment + Crystallised segment*

# The Contributions segment

**The Contributions Segment**

- Consists of contributions made after 30 June 2007.
- Basically the sum of amounts that have not been included in the taxable income of the fund.
- This would include non-concessional contributions as well as non-assessable contributions that do not count towards the non-concessional cap:
  - Contributions that count against the lifetime CGT cap
  - Government contributions
  - Contributions from personal injury claims

# The Crystallised segment

**The Crystallised Segment**

- The Crystallised Segment of a superannuation interest is the value of the following existing components as at 30 June 2007:

  - Undeducted contributions
  - Post June 1994 invalidity
  - CGT exempt
  - Pre 1 July 1983
  - Concessional.

- Where a member had any of these components as at 30 June 2007 this amount was ‘frozen’ and is used when calculating the member’s tax free component.

# The Taxable Component

**The Taxable Component**

- The taxable component is simply the total value of the superannuation interest less the tax-free component.

- Positive or negative investment returns are generally applied to the value of the taxable component with regard to a superannuation interest in accumulation mode.

# The Taxable Component

**Example**

- Alex (age 50) made the following contributions to his SMSF:
  - 16 April 2007 - $200,000 undeducted contribution
  - 19 July 2012 - $300,000 non-concessional contribution
  - 23 September 2014 – $30,000 personal deductible contribution
- Therefore the tax free component is $500,000.

# The Taxable Component

**Example**

- The value of Alex's superannuation interest today is $633,000.
- His benefit is in accumulation mode.
- Therefore the taxable component is calculated as follows:
  - $633,000 - $500,000 = $133,000
- All growth is a taxable component when a superannuation interest is in accumulation mode.

# The Taxable Component

**Example**

- Let’s say Alex went into pension mode on 24 September 2014.

- His pension at commencement would be worth $530,000 consisting of:

- Tax free - $500,000 (94.34%)
- Taxable - $30,000 (5.66%)

- If this superannuation interest grows to $633,000 today, it would be 94.34% tax free and 5.66% taxable.

- Tax free - $597,172 (94.34%)
- Taxable - $35,828 (5.66%)

# Modification to tax components

**Insurance proceeds**

- The value of insurance proceeds allocated to a deceased member in pension mode are considered a taxable component.
- ***UNLESS the pension is a reversionary pension*.**
- In that instance the insurance proceeds allocated to the deceased member's pension interest just prior to it reverting would form part of the taxable/tax free components of the pension calculated at commencement.
- A good reason to have a reversionary pension!

# Modification to tax components

**What does 'reversionary' mean?**

- The rules governing the pension state, ***at the start***, the pension is to continue to a beneficiary.
- On the death of the primary pensioner, the secondary pensioner automatically receives the benefit as a ***continuing income stream***.
- A non-reversionary pension means the income stream ***ceases on death***.
- The surviving spouse may then decide to take the deceased's benefit as a lump sum, or a ***new income stream***.
- However the ***original income stream ceases***.

# Modification to tax components

**Case Study – Insurance Proceeds**

- Richard was in receipt of a non-reversionary pension at the time of his death on 1 July 2013.
- The pension benefit in the fund was $600,000 and consisted entirely of a tax free component.
- Richard was covered by a life insurance policy held by the fund.
- The fund was paid $500,000 in respect of Richard’s death.
- The amount was added to the superannuation interest that had supported Richard’s income stream.

# Modification to tax components

**Case Study – Insurance Proceeds (cont.)**

- The Trustee of the fund decides to pay Richard's spouse Emma an income stream.
- The income stream consists of Richard's superannuation interest and the insurance proceeds.
- The benefit started as a pension by Emma would consist of the following components:

| | |
|---|---|
| Tax Free | \$600,000 (54.55%) |
| Taxable | \$500,000 (45.45%) |

# Modification to tax components

**Case Study – Insurance Proceeds (cont.)**

- If Richard's pension had been reversionary to Emma, the insurance proceeds would be the same component as the superannuation interest.
- As the pension was 100% tax free, the insurance proceeds received by the fund would also be tax free.
- So the pension benefit that reverted to Emma would consist of the following components:

| | |
|---|---|
| Tax Free | $1,100,000 (100%) |

# Modification to tax components

**Modification for Disability Benefit**

- Where a member has become permanently incapacitated and they are paid a lump sum benefit the tax-free component can be increased to compensate the member for their lost future service.

- Ordinarily with Total and Permanent Disablement (TPD) payments, if paid as a lump sum, tax is payable at the following rates:

| Age at date of payment | Tax Free component | Taxable component – Taxed element | Tax Rate |
|---|---|---|---|
| **Under Preservation Age** | Tax Free | Total Amount | 20%* |
| **Preservation age to age 59** | Tax Free | First $195,000<br>Excess above $195,000 | 0%<br>15%* |
| **60 +** | Tax Free | Tax Free | 0% |

- *Plus Medicare Levy.

# Modification to tax components

**Modification for Disability Benefit**

- If the member uses the TPD benefit to start an income stream, it will be a commutable Account Based Pension.

- The member will be entitled to a tax offset equal to 15% of the taxable component of the benefit.

- The TPD insurance proceeds will comprise wholly of a taxable component.

# Modification to tax components

**Example - Modification for Disability Benefit**

- Angela is 46 years old (DOB 30 May 1969).
- She stopped work due to her illness on 30 June 2015.
- Angela had $325,000 in an industry super fund. She also has an SMSF with her husband Jeff.
- Her benefit comprised of a $125,000 tax free component and a $200,000 taxable component.
- Angela held a TPD policy in the fund valued at $500,000.
- Angela satisfies the definition of total and permanent disability.

# Modification to tax components

**Example - Modification for Disability Benefit**

- The insurer paid out the proceeds of her TPD policy to her member account in the industry fund.
- As a result, Angela's balance in the fund is now $825,000, comprising the following components:
  - Tax free - $125,000 (15.1%)
  - Taxable - $700,000 (84.9%)
- If Angela commenced the benefit as an income stream she would be taxed on the taxable component at her marginal tax rate less a 15% tax offset.
- If she took the benefit as a lump sum, she would be taxed on the taxable component at 22%, being $154,000 (net benefit = $671,000).

# Modification to tax components

**Modification for Disability Benefit**

- A Disability Superannuation Benefit can increase the tax-free component.

- A Disability Superannuation benefit is:

  - A lump sum paid to a person ***(including a rollover to another superannuation fund)*** because he or she suffers from ill health; and

  - Two legally qualified Medical Practitioners have certified that, because of the ill health, it is unlikely the person can ever be gainfully employed in a capacity for which he or she is reasonably qualified because of education, experience or training.

# Modification to tax components

**Modification for Disability Benefit**

- Calculation of increased tax free component (s307-145 ITAA1997):
- Amount of benefit x $\dfrac{\text{days to retirement}}{\text{service days + days to retirement}}$
- Amount of benefit is the amount of the disability benefit being paid, including insurance proceeds.
- Days to Retirement is the number of days from the day on which the person stopped being capable of being gainfully employed to his or her last retirement day (usually when the Member turns 65 years old);
- Service Days is the number of days in the service period for the lump sum.

# Modification to tax components

**Example - Modification for Disability Benefit**

- If Angela is able to further satisfy a 'Disability Superannuation benefit" definition, *she can rollover the benefit from her industry fund to her SMSF*.

- ***This will increase the tax free component of the superannuation interest***.

- The calculation of the increased tax free component is as follows:

- Amount of benefit x $\dfrac{\text{days to retirement}}{\text{service days + days to retirement}}$

- \$825,000 x $\dfrac{\text{6,910 days}}{\text{16,190 days}}$

# Modification to tax components

**Example - Modification for Disability Benefit**

- $825,000 x .4268 = $352,115 *additional tax free component*.
- The total tax free component is $352,115 + $125,000 = $477,115.
- This will significantly reduce the tax payable on the pension payments received by Angela if she starts a pension in the SMSF.
- The tax free component has increased from 15.1% to 57.83%.
- *Remember we have crystallised the components, so any growth and earnings will be in the ratio of tax free/taxable*.

# Pension Strategies

**Tax on Death Benefits**

- Only a spouse, disabled child, minor child and limited others can take a death benefit as a pension.

- An independent adult child or a member's estate can receive a death benefit, but only as a lump sum.

- Death is a compulsory cashing event – the deceased's benefit must be used to commence a pension, continue a reversionary pension or paid as a lump sum.

- Lump sum going to an independent adult child or the member's estate may be subject to lump sum tax.

# Pension Strategies

**Tax on Death Benefits**

- Lump sum tax is payable as follows:

  - Tax free component — Nil
  - Taxable component — 15%*

* Plus Medicare Levy.

- The tax free component consists of the Crystallised segment and the Contributions segment.

- The taxable component is the rest.

# Pension Strategies

**Non-concessional contribution/re-contribution**

- Let's say a member has a benefit made up of a large taxable component.
- They wish to make a non-concessional contribution – either with new money to super or a re-contribution strategy.
- They should consider starting an account based pension with the benefit in the fund prior to making the non-concessional contribution.
- This strategy allows the member to keep the tax free and taxable components separate by segregating the tax free component into a separate superannuation interest.

# Pension Strategies

**Non-concessional contribution/re-contribution**

- The benefit of this strategy is it allows a member to choose whether to take benefits from their taxable or tax free interest.

- This means they can stream the benefits in a tax effective manner from an Estate Planning perspective, minimising tax when it comes to inter-generational wealth transfer.

- It also allows for the ability to draw lump sums from the taxable pension tax free and have them count against the minimum pension payment standards.

- These could then be re-contributed as a non-concessional spouse contribution to even up member accounts.

# Pension Strategies

**Non-concessional contribution/re-contribution**

- Segregating tax components into separate superannuation interests may also provide benefits where there are blended families.

- If the member dies some of their benefit may be paid to an adult child who could pay lump sum tax on the superannuation benefit.

- In this case, segregating the tax free component into a separate pension allows the trustee to pay a lump sum death benefit tax free to an adult child.

# Pension Strategies

**Case Study 1 – Re-contribution strategy**

- Bill retired in February 2014 at age 63.
- He had $1.5 million in his SMSF – all a taxable component.
- His fund consisted of $500,000 cash and $1 million in shares.
- Bill commences a pension and withdraws $500,000 cash.
- He nominates his spouse Betty (age 60) as the reversionary beneficiary of his 100% taxable pension.

# Pension Strategies

**Case Study 1 – Re-contribution strategy**

- Bill then recontributes the $500,000 as a non-concessional contribution and commences a second non-reversionary pension.

- He now has two superannuation interests as follows:

- Pension 1 (100% taxable) - $1,000,000
- Pension 2 (100% tax free) - $500,000

- Bill makes a Binding Death Benefit Nomination (BDBN) that states on his demise his 100% tax free pension is to be paid to his Son Dan as a lump sum.

- Dan is Bill's son from his first marriage.

# Pension Strategies

**Case Study 1 – Re-contribution strategy**

- Bill passes away in July 2015.
- The $500,000 tax free pension will be paid to Dan as a lump sum.
- Dan will pay no tax on this lump sum (it is 100% tax free component).
- Betty will receive the $1,000,000 reversionary taxable pension.
- The income received by Betty will be tax free.

# Pension Strategies

**Case Study 1 – Re-contribution strategy**

- If Bill had re-contributed the $500,000 non-concessional contribution prior to starting a pension, *he would have one superannuation interest*.

- Pension 1 would consist of the following components:

- Tax free (33%) - $500,000
- Taxable (67%) - $1,000,000

- In this instance the pension would need to be non-reversionary if Bill wanted Dan to receive some of his benefit.

# Pension Strategies

**Case Study 1 – Re-contribution strategy**

- If there was a BDBN it would need to state Dan is to receive 33% of Bill's death benefit.

- Assuming the value of the pension was the same ($1.5 million), the death benefit lump sum ($500,000) received by Dan would consist of the following components:

- Tax free (33%) - $166,667
- Taxable (67%) - $333,333

- Tax payable on the lump sum received by Dan would be:

- $333,333 x 17% = $56,667.

# Pension Strategies

**Case Study 1 – Re-contribution strategy**

- The net benefit received by Dan would be as follows:
- $500,000 - $56,667 = $443,333.
- By structuring his pensions into two superannuation interests, Bill family wealth is increased by $56,667.
- If Bill survives for several more years and the pension accounts grow to $1.1 million and $550,000 respectively, *the components are crystallised*.
- The creates an even greater potential saving for Bill's family.

# Pension Strategies

**Reversionary Market-Linked Income Streams (MLIS)**

- Some SMSF Members established MLIS for Reasonable Benefit Limit (RBL) purposes.
- The Simpler Super changes meant these income streams were no longer required.
- But they are non-commutable – meaning they cannot be cancelled and rolled back to accumulation to start an Account Based Pension.
- Account Based Pensions are far more flexible than MLIS.
- Often MLIS were made reversionary to a spouse.

# Pension Strategies

**Reversionary Market-Linked Income Streams (MLIS)**

- A MLIS can be commuted – but only to start another MLIS.
- The issue with a reversionary income stream – it continues seamlessly to a surviving spouse.
- Therefore a non-commutable income stream will continue to be a non-commutable income stream – for both the primary and secondary pension recipient.
- This will lock the spouse into an income stream that cannot be converted to a lump sum prior to death.
- Also the minimum and maximum income amounts are fixed.

# Pension Strategies

**Solution?**

- Commute the reversionary MLIS to commence a non-reversionary MLIS.
- This pension will then cease on the death of the primary pensioner.
- It will become a death benefit – it can be used by a surviving spouse to commence a new pension (Account Based Pension).
- This provides full flexibility for a re-contribution strategy – to provide a tax free lump sum to adult children.

# Pension Strategies

**Case Study 2 – Commute a reversionary MLIS**

- Sam (70) has a MLIS worth $1 million – all taxable.
- It is reversionary to his wife Jody (62).
- Sam dies and Jody receives the reversionary MLIS.
- Jody cannot stop this pension – other than to commence a new MLIS.
- When she passes away the MLIS capital will be distributed according to her BDBN to their two adult sons.

# Pension Strategies

**Case Study 2 – Commute a reversionary MLIS**

- Sam (70) has a MLIS worth $1 million – all taxable.
- It is reversionary to his wife Jody (62).
- Sam dies and Jody receives the reversionary MLIS.
- Jody cannot stop this pension – other than to commence a new MLIS.
- When she passes away the MLIS capital will be distributed according to her BDBN to their two adult sons.
- They will pay $170,000 lump sum tax on this death benefit.

# Pension Strategies

**Case Study 2 – Commute a reversionary MLIS**

- However, prior to Sam's death, he commutes the reversionary MLIS to commence a non-reversionary MLIS.
- Therefore when he dies the ***pension ceases***.
- His pension reverts back to accumulation mode.
- Jody can then take a tax free lump sum, or commence a new pension.
- If Sam dies and Jody is 62, she can undertake a re-contribution strategy.
- She can convert $720,000 of the $1 million into a tax free component.

# Pension Strategies

**Case Study 2 – Commute a reversionary MLIS**

- Jody could in fact create two pensions:

- Taxable Pension - $280,000
- Tax free Pension - $720,000

- On her death, the two boys will receive the tax free pension capital lump sum tax free.

- If Jody satisfies the work test post 65, she could even withdraw the capital value of the taxable pension and re-contribute this as a non-concessional contribution.

# Issues for Consideration

**Seek guidance before undertaking any pension strategy**

- Make sure the Trust Deed allows for the strategy!
- One needs to take a pro-rata minimum before any commutation.
- The ATO has issued a ruling on when a pension commences and ceases – TR 2013/5.
- If undertaking a re-contribution strategy, be mindful of the caps and eligibility to contribute.
- It is difficult to fix errors after the fact!

# Services to support SMSF Trustees

**Pension Review Service**

- We can review your current pension structure and entitlements to look at ways to enhance your arrangements.
- Fee for service consultation ($385 inclusive of GST).
- Written report outlining current structures and provide options to enhance your pension structures.
- You can then decide if you want to implement the options we provide.
- There may be additional fees if you require assistance in the implementation of options, but we will discuss these with you prior to implementation.

# Services to support SMSF Trustees

**How can we help?**

- Contact your Fund Accountant or Client Service Representative for:
  - Trust Deed upgrade
  - Pension documentation
- Use your Dashboard functionality to ensure you track your pension payments and caps.
- Advice – technical, structuring and procedural advice for your specific circumstances.

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