NTAA

ADVICE

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Unsegregated method mandatory for some SMSFs from 1 July 2017

Traditionally, super funds that are paying pensions have two choices for determining how much of their income is exempt from tax under the pension earnings exemption, being the **segregated method** or **unsegregated method** (often also referred to as the 'proportionate method'):

- **Segregated method** – if a fund holds an asset solely to fund a pension, that asset will be a *segregated current pension asset*. Any income derived from that asset is exempt from tax.
- **Unsegregated method** – under this method, a proportion of *all* of the fund's income is exempt from tax, being the value of the fund's current pension liabilities as a percentage of the fund's total liabilities, as specified in an actuary's certificate.

Unfortunately, commencing from 1 July 2017, new rules take effect whereby certain SMSFs are not permitted to use the segregated method to calculate their exempt pension earnings. More specifically, from 1 July 2017, the assets of an SMSF are not segregated current pension assets (which means they are *unsegregated assets*) where they are **'disregarded small fund assets'**.

Funds affected by this change are required to use the unsegregated method to calculate the fund's exempt pension earnings. One consequence of this is that the trustee is required to obtain an actuarial certificate, which is generally not required where the segregated method is used.

An asset of an SMSF will be a **disregarded small fund asset** where:

(a) at a time during the income year at least one member is drawing an account-based pension from that fund; and

(b) just before the start of the income year:

- any member of the fund has a 'total superannuation balance' **exceeding** $1.6 million; and
- that member has an account-based pension interest in any superannuation fund.

Based on the above requirements, any SMSF with an account-based pension that is affected by the new $1.6 million 'transfer balance cap' in the 2017 income year will generally be required to use the unsegregated method to calculate the pension earnings exemption for the 2018 income year.

Commutation of a death benefit income stream before 1 July 2017

The ATO has recently released a practical compliance guideline (**PCG 2017/6**) in relation to a commutation of a death benefit income stream that occurs before 1 July 2017.

This guideline addresses the practice of a deceased member's spouse rolling over a death benefit income stream and retaining the amount as their own superannuation interest without immediately cashing out that benefit.

The ATO expresses the view in this guideline that this approach does not satisfy legislative requirements. It further notes that a roll-over by a spouse of a deceased member's death benefit income stream does not change a superannuation provider's regulatory requirement to cash the deceased member's superannuation interest as soon as practicable.

Therefore, the superannuation provider that has received the rolled over death benefit must immediately cash the deceased member's superannuation interest, either as a superannuation lump sum, or as a death benefit income stream, or a combination of the two.

However, the ATO says it will not review whether there is compliance with the compulsory cashing requirements provided:

- the member of the SMSF was the spouse of the deceased on the deceased's date of death;
- the commutation and roll-over of the death benefit income stream is made before 1 July 2017; and
- the superannuation lump sum paid from the commutation is a member benefit for income tax purposes because it meets the relevant legislative requirements.

This is illustrated in the example below (taken from PCG 2017/6):

Henry dies on 1 January 2015. At the time of Henry's death he was in receipt of a pension from the Jackson Superannuation Fund valued at $1,000,000. This pension reverts to Henry's spouse, Kate.

Kate has her own accumulation phase interest ($500,000) in the Kate SMSF and wishes to consolidate all of her superannuation entitlements. Therefore, on 1 August 2015 Kate instructs the Jackson Superannuation Fund to commute the reversionary superannuation income stream in full and roll the amount over to her accumulation phase interest in the Kate SMSF.

The superannuation lump sum resulting from the commutation meets the relevant legislative conditions.

The Commissioner will not review whether or not the Kate SMSF has complied with the compulsory cashing requirements related to the death benefit.

Re-contribution strategy exceeded non-concessional contributions cap

In a recent decision, the AAT held that excess non-concessional contributions made by a taxpayer as a result of a re-contribution strategy could not be disregarded by reason of special circumstances.

In October 2010, the taxpayer, acting on the advice of a financial adviser, withdrew approximately $330,000 from one of his superannuation funds and re-contributed it back into another superannuation fund as a non-concessional contribution ('NCC').

In October 2012, again acting on the advice of a financial adviser, the taxpayer made a further NCC of $325,000.

The ATO wrote to the taxpayer in March 2015 advising that he had exceeded the three-year NCC cap by approximately $200,000.

The taxpayer asked the ATO to disregard his NCC for the 2012/13 income year or to reallocate it to another year, but he was told there were no 'special circumstances' that allowed the ATO to do so.

On appeal to the AAT, the taxpayer argued that the re-contribution strategy did not in fact constitute an NCC, as no 'contribution' had been 'made', applying the principles set out in the Practice Statement PS LA 2008/1. The taxpayer also submitted that during the course of the re-contribution strategy, the balance remained internally with the fund provider and was simply 'rolled-over'.

However, the AAT did not accept the taxpayer's arguments, and noted that PS LA 2008/1 merely summarises the typical ways in which superannuation funds are transferred and the point in time in which the corresponding contribution is made (and in any case, PS LA 2008/1 was merely a guideline and was not binding on the AAT).

The AAT applied the ordinary meaning of 'contribution', and decided that the re-contribution strategy clearly resulted in a contribution being made to the taxpayer's superannuation account. Therefore, the re-contribution strategy clearly constituted an NCC by the taxpayer.

Also, the AAT did not accept that either the taxpayer's health problems when the contributions were made, or the financial advice that the taxpayer received and acted on, constituted 'special circumstances' required for the ATO to exercise its discretion. Therefore, the AAT upheld the ATO's decision.

Refer *Pitts v FC of T* [2017] AATA 685, 12 May 2017.

SMSF dividend washing trades in breach of anti-avoidance provisions

In a recent decision, the AAT affirmed the ATO's decision that the taxation anti-avoidance provisions applied to dividend washing trades so that no imputation benefit arose in respect of distributions made as a result of the scheme.

By way of background, an SMSF held shares listed on the Australian Securities Exchange (ASX) in the 2012 and 2013 income years, and also bought and sold shares on the ASX during this period.

The SMSF entered into a number of matched, sequential trades of shares (the 'dividend washing trades') where it would sell a parcel of shares in a listed company on the ordinary market on or shortly after the day the shares had begun trading on an ex-dividend basis. The SMSF would then purchase an equivalent parcel of shares in the same company on a cum-dividend basis in the brief period in which the necessary special market conditions operated following the shares becoming ex-dividend.

The ATO held that the SMSF was not entitled to a tax offset in respect of the shares held for less than 45 days, and also that, under the anti-avoidance provisions, no imputation benefit (franking credits) arose in respect of the franked distributions received from the shares purchased cum-dividend from the dividend washing trades.

On appeal, the AAT found that the anti-avoidance provisions applied to the dividend washing trades and the ATO was correct in determining that no imputation benefit arose in respect of the distributions or parts of a distribution made as a result of the scheme.

The AAT held that the purpose of the dividend washing trades was clearly to obtain an imputation benefit as the SMSF was able to offset tax liabilities by the amount of the franking credits attached to the distributions. The trustee's purpose was the only purpose of conducting the transactions, as the SMSF would have made a loss on the transactions if the additional franking credits on the purchase transactions were ignored.

Therefore, the SMSF was not entitled to a tax offset in respect of those shares that had been held for less than 45 days.

Refer *Lynton ATF the David Lynton Superannuation Fund* [2017] AATA 694, 17 May 2017.