

Tech Time



Perpetual's monthly technical guide

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Changes to superannuation instalment warrant arrangements

The Government released the Superannuation Industry (Supervision) (SIS) Amendment Bill 2010 (Bill) which provides clarity around borrowing within super through an instalment warrant arrangement. The changes are proposed to commence after the Bill receives royal assent. Please note: it passed the senate on the 24th of June 2010.

Schedule 1 of the Bill proposes a number of changes to the SIS Act to help protect superannuation fund assets in the event of a default on a limited recourse borrowing arrangement.

One of the key proposals is that the borrowing is referable and identifiable only over a single asset (excluding money) or in prescribed circumstances, over a collection of assets which are identical and are treated as a single asset.

This change would mean that you could not use an instalment warrant arrangement to invest in a portfolio of different shares as this would include a number of parcels of shares in different companies and at different prices. If a super fund wished to invest in a number of separate assets, it would be necessary to have a separate instalment warrant arrangement for each of those assets. This would add significant costs to the super fund.

Examples of single assets include shares of the same type in a single company, and units in a unit trust that have the same fixed rights attached to them. For example, the asset may be all BHP Billiton shares but not a portfolio of BHP Billiton and Rio Tinto shares.

If passed unamended, it is envisaged that borrowing in super will be restricted to the following types of assets:

- a single property
- a single type of share or managed investment
- where a portfolio of shares is required, shares in a single listed investment.

The Bill also provides clarity around the circumstances under which refinancing and related expenses are permitted. The Bill clarifies that the original asset can be 'maintained' or 'repaired' to ensure that its functional value is not diminished, but the asset cannot be 'improved' as this could fundamentally change the nature of the asset used as security by the lender and potentially increase the risk to the fund.

Superannuation reserves

What are reserves and how can they be used effectively?

A reserve is made up of amounts set aside in a fund to provide for future payments. There are a number of reasons why they may be used, including:

- to smooth the income of the fund credited to members' accounts
- as contributions to members' accounts
- to increase death benefits payable to the immediate family of the deceased
- to support pensions payable from the fund.

It is important to ensure that reserves are permitted by the trust deed, under the SIS Act section 115, and that the trustees have developed a reserving strategy that is in place, under the SIS Act section 52 (2)(g).

What types of reserves can be established?

The following are the main types of reserves that may be used:

1. **Contributions reserve**
2. **Actuarial / pension reserve**
3. **Investment fluctuation reserve**
4. **Miscellaneous / general reserve.**

1. Contributions reserve


Contributions made to a self managed super fund (SMSF) are allocated to this reserve as opposed to being directly allocated to the members' accounts. Since 12 May 2004 any new additions must be allocated to the members' accounts within 28 days after the end of the month in which the contributions are made. Any existing money held in the reserve that was not vested could remain in the reserve and be allocated as trustees deem appropriate.

In the past, contributions reserves were used to avoid superannuation surcharge tax and to provide for contribution splitting. However, with surcharge tax being abolished and contribution splitting now available for concessional contributions, the reason for their use has changed somewhat.

Contributions reserves are now more likely to be used similar to a clearing house. Contributions come into the reserve and any joint expenses are paid, such as advice fees or insurance premiums.

The net contribution amount must then be allocated to the member's account within 28 days from the end of the month the contribution was initially made. For example a concessional or non-concessional contribution made to a reserve in June must be credited to the member's account by 28 July, under SIS Act regulations 7.09 to 7.11.

From a practical perspective, transfers from reserves made in lieu of a contribution to the fund need to be grossed up by 1.176 to take account of the notional tax payable. For example, John's employer decides not to contribute to the fund this year. Instead, the fund trustee decides to transfer an amount of \$850 to John's account in lieu of a contribution. This amount would be reported as a \$1,000 contribution ($\850×1.176).


 **Tech tip:** Transfers from reserves are not considered contributions for the purposes of the SIS Act regulation 7 and therefore amounts can be transferred from reserves at any age (National Tax Liaison Group minutes 3 December 2008 item 6.8).

The contribution is a reportable superannuation contribution in the year the transfer takes place.

2. Actuarial / pension reserve

This type of reserve is established by the fund actuary, usually to help the fund meet its obligations to pay defined benefit income streams, that is non-account based income streams.


Actuarial reserves can also be referred to as pension or solvency reserves. The reserve's balance is calculated by the SMSF's actuary based on the capital used to purchase the income stream and the amount set aside in the actuarial reserve in order to support the guaranteed nature of these income streams.

 **Tech tip:** This type of reserve is only relevant for defined benefit income streams. SMSFs cannot pay a defined benefit pension unless the SMSF was established on or before 12 May 2004 and at that date the trust deed or governing rules of the fund allowed for defined benefit pensions.

3. Investment fluctuations reserve

An investment fluctuations reserve is used to smooth investment fluctuations in accumulation funds. The reserves are built up and used to smooth the year-to-year returns credited to members' accounts. As a result, the market linked investment returns are not as volatile as they would have been without the smoothing.

These are set up by holding back some of the investment income for a particular year, when fund earnings are high, and not allocating it to members' accounts. At some later stage, the trustees can allocate a portion or the entire amount of the reserves to the fund members in a year when returns are low.

 **Tech tip:** Superannuation Contributions Ruling SCR99/1 states that 'generally the opening balance of the investment (fluctuations reserve) may not exceed 15% of the net market value of the assets at the opening balance date.' While this ruling was introduced at a time when surcharge tax was in place, it is recommended that the 15% limit is adhered to until the ATO provides any further clarification.

An investment fluctuations reserve may be a useful strategy to help ensure that account based income streams produce an annual income stream that is relatively constant.



4. General / miscellaneous reserve

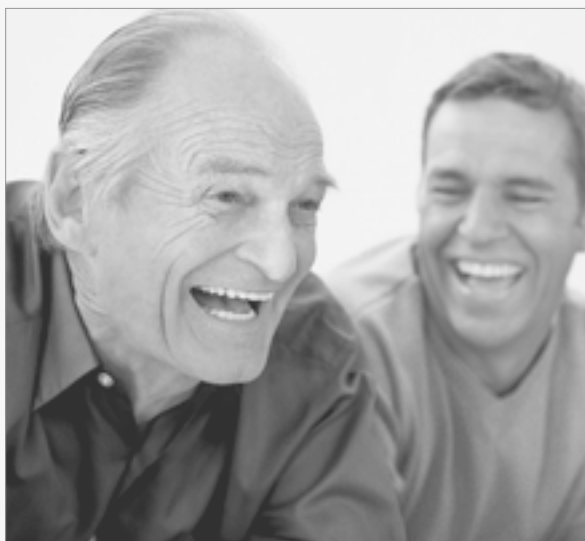
A general reserve, otherwise known as a miscellaneous reserve, can arise in a SMSF as a consequence of the transfer of funds from an actuarial reserve. This occurs where the actuarial reserve backing the defined benefit pensions is deemed to be more than the liability to which it related. Where this occurs the identified amount can be transferred back to a general reserve for the benefit of all members.

Transfer to a general reserve may also arise as a result of one of the following:

- early commutation of a commutable defined benefit pension
- termination of a defined benefit pension (on death)
- reaching the end of the defined pension's specified term.

Example

Hugh is aged 60 and commenced a \$650,000 lifetime pension in his SMSF in July 2000. He would like to commute the pension and move to an account based pension. The current account balance is \$750,000 and the commutation value has been identified as \$400,000 and as a result \$350,000 will be transferred to a general reserve.



When will a transfer from a reserve count toward the contribution caps?

Certain allocations from reserves may be treated as concessional contributions and captured under the concessional contributions cap. However, this does not mean that the allocations are subject to contributions tax, but simply that they are subject to the concessional contributions cap.

Allocations made in excess of the concessional contributions cap and any other subsequent concessional contributions cap would then be taxed at the highest marginal tax rate and subject to the non-concessional contributions cap.

Allocations may also be counted under the non-concessional contributions cap if they are allocations made from the reserve where the allocation was originally a non-concessional contribution made into the reserve.

The following transfers will generally not be treated as a contribution under the caps and as a result will not count towards any of the caps:

- benefit is allocated to all members of the fund to which the reserve relates and is less than 5% of the value of the member's interest in the fund at the time of allocation
- benefit is used to satisfy a pension liability due during the year
- benefit arises from commutation of a pension which is allocated to the primary beneficiary and used to commence another pension for that person
- on the death of the primary beneficiary the amount is allocated to fund a death benefit pension for an eligible beneficiary or paid as a death benefit lump sum.

For example, let's take Hugh's case from above. Should the trustee allocate all of the reserve from the commutation of Hugh's pension to another member or to an accumulation account for Hugh, the allocation will count towards the recipient's concessional contribution cap and the excess will be taxed at 31.5%.

However, if the reserve amount is used to purchase another pension for Hugh, the amount used to commence the pension will be exempt from both the concessional and non-concessional contribution caps.

Taxation considerations

Reserves are always considered to be assets of the fund and not part of members' accounts and for this reason any earnings on reserve accounts are always taxed at the superannuation tax rate of 15%.

Centrelink considerations

Reserves are considered assets of the fund and not the member and therefore are not likely to be captured under the assets and income test for Centrelink purposes.

Estate planning considerations

Trustees should ensure that the membership of the fund offers flexibility in estate planning with regard to any reserves.

The trustees may wish to consider making provisions in the trust deed to allow another person to be automatically admitted as a member on the death of another. This means that they are excluded from the decision making until the death of the member, however they can receive an allocation from the reserves upon death.

It is also possible to admit non-contributing members if allowed by the trust deed. This gives the trustee greater flexibility when allocating amounts from the reserves to members who are ineligible to contribute.



Tech tip: If a member of an SMSF dies and there are no other surviving members of the fund, and the reserves are not properly allocated or dealt with in the trust deed, there is the possibility that the reserves will become an asset of the Crown.

More specifically, SMSFs can use reserves to self fund temporary disability payments which is especially useful to top-up existing policies or create a pool of money if the member is otherwise unable to obtain insurance.

In the event of a member's death, dependants can apply for a refund of any contributions tax paid, which allows a fund to claim a tax deduction for the amount of the contributions tax that has been paid in respect to contributions for that member. To fund this payment, reserves are often the preferred mechanism.

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