

Tech Time



Perpetual's monthly technical guide

In this edition:

- ▶ **Deduction for life insurance premiums**
- ▶ **Selling assets in pension phase**

Deductions for life insurance premiums

The Tax Act provides superannuation funds with two methods for claiming a deduction where the fund pays life insurance premiums:

1. Claim a deduction for the actual premium paid. Deductions may generally be claimed for death, total and permanent disability, and income protection insurance premiums.
2. Claim a deduction for part of a lump sum death or disability benefit, if the benefit is paid before the member's 65th birthday.

The second method may give the fund a substantial tax deduction, which could offset taxes on contributions and earnings for several years. While the trustees must make an election to adopt the second method, the election does not need to be made until the trustees lodge the tax return for the year the death benefit is paid.

Calculating the deduction

Where a death or disability benefit is paid before the member's 65th birthday, the fund may claim a deduction for the part of the benefit that represents future service. The following formula is used to calculate the deduction.

$$\text{Deduction to fund} = \text{Benefit amount} \times \frac{\text{Future service days}}{\text{Total service days}}$$

Future service days = days from the date of termination of employment or death until normal retirement, usually age 65

Total service days = past service days plus future service days

Case study

- Maude was a member of the Flanders Superannuation Fund.
- She died on 30 June 2010.
- Her fund held a \$400,000 life insurance policy over her life.
- Her account balance was \$100,000.
- The total proceeds were paid to her husband, Ned.
- Her service period commenced on 1 July 1988 and her normal retirement date would have been 1 July 2020:

The Flanders Superannuation Fund may claim the following deduction:

$$\begin{aligned} \text{Deduction} &= \$500,000 \times \frac{3,654}{11,688} \\ &= \$156,314 \end{aligned}$$

If the fund does not have sufficient income and/or taxable contributions to fully offset the deduction, the excess may be carried forward to future years.

Election to claim deduction based on future service

The trustees of a fund must make an election to claim a deduction based on future service, however the election does not need to be made until lodgement of the tax return for the year in which a death or disability benefit is paid. Thus the trustees may claim a deduction each year for life insurance premiums and may then claim a deduction for the future service portion of a death or disability benefit, effectively claiming a double deduction.

Once the trustees make an election to change the basis for claiming a deduction for life insurance, it will apply to all future years, unless the Commissioner of Taxation gives permission to revert to claiming a deduction for ongoing premiums. As the fund is likely to obtain a substantial tax deduction by making the election, it is unlikely that the trustees would obtain permission to change back to the old method. The lack of a deduction for future life insurance premiums would need to be considered before making an election to change the deduction method.

Conclusion

The alternative method for claiming a deduction provides a particular benefit to self managed superannuation funds as it allows the fund to claim a deduction for premiums each year, then to change the method for claiming a deduction after payment of either a death or disability benefit. This will be beneficial when the fund has other members who may benefit from tax deductions generated. Members need to be aware that the election to change the method for claiming a deduction applies to future years, so they need to factor in the loss of a deduction for life insurance premiums in future years.



Tech tip: Where a superannuation fund pays a death or disability benefit on behalf of a member before their 65th birthday, it may elect to change the basis for claiming a deduction in respect of life insurance premiums. This may result in a large additional deduction which may be carried forward to offset against tax on future contributions and earnings, which will be of benefit to continuing members.

Selling assets in pension phase

Fund returns to accumulation phase on death

The Australian Taxation Office (ATO) has stated (in ATOID 2004/688) that, in its opinion, a member's superannuation pension ceases on death and returns to the accumulation phase when the member dies. Accordingly, the tax exemption applicable to pension assets ceases on the member's death.

If the death benefit is payable to a person who cannot receive an income stream, eg an adult child or a person who is not a superannuation dependant, the fund will realise a capital gain either when assets are sold to pay a benefit, or are distributed as an in specie benefit. Any CGT liability will be based on the original cost base of the investment.

Case study

Kenny died on 30 November 2010. His fund had been paying him an account based pension for the last five years. He had no dependants and his entire superannuation benefit passed through his estate to his brother Kevin.

Kenny's fund's assets include a property which was purchased in 1990 for \$100,000 and is currently worth \$400,000. If the property is either sold to pay a death benefit or is distributed in specie as a death benefit, the fund will realise a capital gain of \$300,000. This will result in a CGT liability of:

$$\$300,000 \times 2/3 \times 15\% = \$30,000$$

It should be noted that when a fund moves from pension back to accumulation phase and a capital gain is realised, the full gain is taxable, there is no reduction for the fund having been in pension phase for some or all of the time the asset was held. Conversely, if an asset is disposed of when the fund is in pension phase, no part of the gain is taxable, even if the asset was acquired while the fund was in accumulation phase.

Recommended strategy

Where a SMSF is paying a pension, advisers should review the fund's investments on a regular basis. Where an investment has a large unrealised capital gain, consideration should be given to selling the investment so that the gain is realised while the fund is exempt from tax.

Caution against CGT 'wash sales'

Fund members should be careful of arrangements which involve selling assets and purchasing the same or similar assets a short time later. It is possible the ATO will consider this to be a 'wash sale' and may seek to apply the general anti-avoidance provisions of Part IVA of the Income Tax Assessment Act 1936.

A 'wash sale' refers to a transaction in which assets are bought and sold within a short period, including purchases from and sales to a related party such as a family trust, where it was intended to retain an economic exposure to the asset.

The ATO has considered wash sales in TR2008/1 and notes that Part IVA could apply to a wash sale, however, the ruling does not consider the sale of assets by SMSFs paying pensions. The ruling considers the sale of an asset to realise a capital loss to offset a capital gain.

While the ATO has not specifically indicated whether it will seek to apply Part IVA to 'wash sales' made by SMSFs in pension phase, caution should be exercised where the sale and purchase of the same or similar assets may take place in a short time period.



Tech tip: Advisers should regularly review their clients' investments where their funds are paying income streams. Where there are large unrealised capital gains, consideration should be given to realising the gains sooner rather than later. If, on the member's death, the benefit passes to a beneficiary who cannot receive an income stream, eg an adult child, the fund moves back to accumulation and CGT will apply on disposal of investments based on the original cost base.

This analysis has been prepared by Perpetual Investment Management Limited (PIML) ABN 18 000 866 535, AFSL 234426 Perpetual Superannuation Limited (PSL) ABN 84 008 416 831 AFSL 225246 RSE L0003315 for the use of financial advisers only, it is general information and is not intended to provide you with financial advice. The technical interpretations expressed in the article are the opinions of the author at the time of writing and do not constitute a recommendation to act. Any information referenced in the article is believed to be accurate at the time of compilation and is provided by Perpetual in good faith. To the extent permitted by law, no liability is accepted for any loss or damage as a result of any reliance on this information.



Further information

Adviser Services 1800 062 725

Investor Services 1800 022 033

Email investments@perpetual.com.au

www.perpetual.com.au