



AUGUST 2014

The August Investor Update

- Welcome to the AIA August Investor Update. We begin with a thought-provoking article by Jon Kalkman (AIA Director) concerning the various taxation aspects of superannuation, in the light of the publicity around the government's search for tax savings. We have an article concerning segregated bank accounts and one concerning the treatment of SMSF property profits as capital gains and other SMSF issues.

Note also the Morningstar offer for AIA members to attend their October one-day conference for \$69

In this issue

- ◆ **The government is looking for tax savings**
Jon Kalkman
- ◆ **Segregated bank accounts are now made easy, so why have unsegregated assets?**
Krishna Skandakumar
- ◆ **SMSF Alert**
 - ◆ Liam Shorte and Richard Livingstone highlight key recent SMSF developments

The government is looking for tax savings.

Jon Kalkman, AIA Director

According to the Murray Financial System Inquiry, dividend imputation creates a bias in the system because income from other investments including bank deposits and fixed interest investments do not have the same concession.

The reason for that incongruity is simple. If banks paid tax on bank deposits before the interest was paid, the depositor would need to take that tax already paid into account before they prepared their own tax return. Unless the tax already paid was a tax credit to the depositor, the interest on the bank deposit would effectively be paid taxed twice; once by the bank and again by the depositor.

Upcoming Events

Adelaide Information Evening Estate Planning

The German Club,
2nd September 2014 7.00pm

Geelong Discussion Group

St George Workers Club
2nd September 2014 7.00pm

Perth Information Meeting

Wembley Downs Tennis Club,
2nd September 2014 7.00pm

Brisbane Information Meeting

Broncos Leagues Club,
3rd September 2014 1.00pm

South Sydney Discussion Group

Miranda Community Centre,
3rd September 2014 7.30pm

Canberra Discussion Group

Canberra Labour Club,
8th September 2014 7.30pm

Sydney North Shore Information Evening

The Chatswood Club,
10th September 2014 7.30pm

Frankston South Discussion Group

Private Address,
10th September 2014 1.00pm

Chermside Equities Discussion Group

The Chermside Library
15th September 2014 7.00pm

The government is looking for tax savings (Cont'd).

This is precisely the situation that applied to dividends from Australian shares before 1987. Dividends are always paid out of after-tax profits. Until 1987, companies paid tax on their profits at the company tax rate, which was then as high as 39% and dividends were then taxed again in the hands of the shareholder at their marginal tax rate which was as high as 60%. With these punitive rates of tax there was little incentive for companies to pay dividends. Many companies preferred to reinvest the after-tax profit into the business and many shareholders preferred to take their investment returns as capital gains which were then lightly taxed. That situation still applies in the US and possibly explains the greater volatility of the US stockmarket.

Since 1987 the dividend imputation system has been straight forward. If a company makes \$100 in profits and the company tax rate is 30%, then \$30 is sent to the ATO and \$70 is sent to shareholders as a dividend. The dividend carries a tax credit to the shareholder for the tax already paid. These tax credits are sometimes called franking credits because after a letter goes through a franking machine it comes with postage paid. These tax credits are described as imputation or franking credits and these terms are used interchangeably.



A PAYG taxpayer has tax withheld from their wages by their employer but their taxable income includes both their take-home pay and the tax already paid by their employer. Similarly, a shareholder's taxable income includes the dividend and the franking credit because this tax has already been paid to the ATO on their behalf. Importantly, the franking credit is a tax credit that can be applied to their tax liability from their dividends and any other income.

Clearly if the company tax was lower, the franking credit would be lower but the dividend, all else being equal,

would be higher and the shareholder's taxable income would be unchanged. Similarly, if there was no company tax, all company profits would be taxed in the hands of Australian shareholder at their marginal rate, but non-residents who pay no personal income tax here, would receive their dividends tax-free. No Australian government would allow that.

The purpose and effect of the dividend imputation system is to ensure that shareholders pay tax on their dividends at their marginal rate and no more. *It is not a tax concession to shareholders.*

Until 2001, imputation credits could be used to offset other tax liabilities only up to the limit of those tax liabilities. Any excess credits were simply lost to the taxpayer. Since 2001 any imputation tax credits in excess of tax liabilities are refunded in cash. Taxpayers whose marginal tax rate is lower than the company tax rate obviously benefit from this tax refund. Taxpayers whose marginal tax rate is higher than the company tax rate clearly need to make up the difference.

In superannuation it is important to distinguish between the super fund as a taxpayer and the member of that fund who is also a taxpayer.

Superannuation needs to be seen as two separate phases because they have two distinct tax treatments. In the accumulation phase before retirement the fund pays tax on concessional contributions and investment income and capital gains. Concessional contributions are those that have tax concessions attached and include employer contributions, salary sacrifice contributions and contributions for a tax-deduction has been claimed. The tax on contributions is 15% and the tax on investment income is also 15%. The tax on capital gains is two thirds of the income tax so it is 10%. Non-concessional contributions are contributions made with after-tax money and do not attract a contributions tax inside the super fund.

A superannuation pension is only available after retirement. It is important to remember that superannuation was introduced in 1992 as a benefit available to all rather than a few senior public servants and business executives. For more than 20 years a super fund paying a pension has not paid tax on its income or capital gains. Investments in this tax-free environment are clearly intended to prolong the fund's capacity to support the superannuant in retirement. Conversely, any tax on a pension fund will curtail the fund's capacity to provide retirement income. In the context of rising life-expectancies this is significant.

Despite their tax-free status, superannuation pensions do have a restriction that is not immediately obvious. To comply as a super pension fund, the member must withdraw a minimum percentage of the value of their fund each year and that minimum increases with age so that eventually all of the capital is removed from this tax haven and then subjected to normal tax rates. This is to ensure that the money in superannuation is used to support the superannuant in their retirement and not passed on to their heirs as a tax-concessional gift. Failure to comply with this rule means the super fund is regarded as an accumulation fund and taxed accordingly.

Until 2007, a member who took a superannuation pension paid normal tax on their pension but they were entitled to claim a tax offset of 15% which was to compensate them for the 15% contributions tax they paid in accumulation phase. That tax on pensions was abolished in 2007 for people over 60. It is important to note that this tax on pensions still applies to people who access a super pension under the age of 60. These people can take a super pension of \$44,500 and still pay no tax because the 15% tax offset is equal to the tax liability. Therefore a couple under the age of 60 can today draw a combined pension of \$89,000 and pay no tax.

It is also important to note that the member's tax on a super pension only applies to the concessional portion of the pension. If a member's fund was comprised 50% concessional contributions and 50% non-concessional contributions, that member under age 60 could take a tax-free pension twice as large because half would be subject to the tax outlined above and half of the pension would be a return of their own money and therefore is also tax-free.

It is interesting then to speculate how much tax would be collected from members of super funds paying pensions if the old tax regime was still in place. This question pivots on the number of people drawing more than \$44,500 per year from their concessional portion of their super fund. If there are few members in this category, any reintroduction of tax on pensions after age 60 would collect little tax, as was the case before 2007.

The proportion of concessional to non-concessional contributions is more critical than many realise. Today's annual cap on concessional contributions of \$35,000 for people over 50 and \$30,000 for people under 50 means it would take more than 30 years to accumulate \$1 million, disregarding investment returns. By contrast the annual cap on non-concessional contributions is

\$180,000 and it is possible to contribute 3 years of contributions or \$540,000 at one time. So a couple with adequate resources could contribute \$1,080,000 every three years. This money would be free of contributions tax and once inside a super fund and it would be free of income tax and capital gains tax when they start a pension. It would also dramatically alter their tax position if they needed to pay tax under the age of 60 or if their children had to pay tax on their death benefit.

The refund of unused imputation credits and the tax-free status of super pension funds together explain the popularity of Australian shares inside SMSFs. Because the marginal tax rate is zero, the imputation credits are refunded in cash to the fund on completion of the fund's tax return. Using the example above, if the fund receives a \$30 refund in addition to a \$70 paid in dividend, the tax refund is more than 40% greater than the dividend itself. Retail and industry super funds paying pensions also receive a refund for their imputation credits but the lack of transparency around their operations means that most members of these funds are unaware of the benefits that Australian shares bring to their retirement savings. That notwithstanding, fund managers most certainly are aware of these tax benefits.



In the context of the government looking for tax savings there have been a number of suggestions made, each would have far reaching consequences

- The abolition of imputation credits would simply mean a reversion to the double taxation of dividends that applied before 1987. It would also decimate those shares which have become popular because they pay high fully-franked dividends. The impact on superannuation funds is incalculable but since the superannuation system is now so large, the impact on the sharemarket would be profound. In addition to super funds, it would adversely affect every Australian shareholder.
- Allowing dividends to be considered as tax-paid by virtue of the imputation credit but without a cash refund for taxpayers on low marginal tax rates would discriminate between taxpayer as some would benefit from these tax credits and others not at all. This would not be politically popular.

- Taxing super pension funds at the same rate as accumulation funds would reduce the fund's capacity to pay a retirement income and therefore place greater strain on the age pension. In addition, it would make the two types of funds indistinguishable. No one would then have a pension fund where the member is required to take more pension than they need and in the process deplete the capital remaining in this low-tax environment. There would also then need to be a death tax to stop a member's heirs benefiting from this tax haven.
- Returning to a regime where pension were taxed in the hands of members after the age of 60, besides being politically fraught, would collect little tax as was the case before 2007.

The tax concessions lost to funds with large non-concessional contributions in pension phase are more significant than the tax concessions lost to high income earners using the 15% tax on their contributions (which are severely limited in any case), rather than their own marginal tax rate.

If we are going to return to a concept of a reasonable benefit limit, beyond which a member should enjoy no further tax concessions, the obvious place to start would be look at the level of non-concessional contributions now that there are such strict limits on concessional contributions.

Placing limits on the size of the pension fund would automatically limit the size of the tax concession associated with that fund. If we could agree on the size of a fund required to provide a comfortable retirement as well as a reasonable level of tax concessions, there could easily be a tax on funds over a certain size or there could be a lifetime cap on these non-concessional contributions.

Clearly, a situation in which pension funds can have \$20 million or more comprising mainly non-concessional contributions and borrowings is unsustainable if it means they can draw a pension of more than \$1 million per year and pay no tax. On the other hand, for a couple who have worked hard to accumulate a nest egg that ensures them a comfortable retirement income, the present tax arrangements around super and Australian shares can mean the difference between being self-funded retirees and dependent on the age pension for all or part of their retirement income.

The issue revolves around what is regarded as a reasonable amount a person should be allowed to have

in super with all its associated tax concessions. That depends very much on your point of view.

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Segregated bank accounts are now made easy, so why have unsegregated assets?

By Krishna Skandakumar

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The ATO released Taxation Determination 2014/7 ('TD 2014/7') on 9 April 2014 entitled 'Income tax: in what circumstances is a bank account of a complying superannuation fund a segregated current pension asset under section 295-385 of the Income Tax Assessment Act 1997 (Cth) ('ITAA')?'. Broadly, TD 2014/7 adopts a much more practical approach to dealing with bank accounts, and more specifically sub-accounts, than its predecessor Taxation Determination 2013/D7 ('TD 2013/D7'), which was withdrawn on 11 December 2013.

One drawback of TD 2014/7 is that it focuses on bank accounts and term deposits without considering other assets, including shares. Unfortunately, based on past ATO comments that an asset must be solely (ie, physically) segregated and that part of an asset cannot be segregated, we should not assume the principle in TD 2014/7 will apply in other situations. At this stage, the ATO has only expressly relaxed its former view in respect of bank accounts, and we expect more ATO news to follow in regards to other assets.

What does TD 2014/7 say?

Broadly, TD 2014/7 focuses on when a bank account is considered to be held solely to enable, or for the sole purpose of enabling, a fund to pay pension liabilities as they fall due. This is more commonly referred to as a 'segregated current pension asset'. The determination provides examples in relation to bank accounts and sub-accounts, and also informal sub-accounts maintained by the trustee of a complying superannuation fund (or for the purposes of this article the trustee of an SMSF).

There are six examples that are considered in TD2014/7 that illustrate when a bank account will be, or will continue to be, a segregated current pension asset, and provide an interesting development in the Commissioner's view.

Example 1 — separate asset

This is the least contentious example and is consistent with the Commissioner's former view expressed in TD 2013/D7.

Broadly, the example deals with an SMSF that has a bank account and a term deposit that is maintained solely to support a pension, and another bank account used to hold another member's accumulation interest. There are also other shared assets of the fund. However, the accounting records and financial statements deal with the bank account and term deposit supporting the pension liabilities separately, on the basis that they are held for different purposes.

In this circumstance, the bank account and term deposit supporting the pension liabilities is considered a segregated current pension asset.

Example 2 — a sub-account maintained by accounting software

The Commissioner then considers a large fund with a single bank account for many members, in which a sub-account is assigned and maintained for the benefit of each member. The fund's accounting software allows

each sub-account to be segregated and maintained on a daily basis.

In this circumstance, the Commissioner states that the sub-account that is allocated to a pension member will be a segregated current pension asset.

Example 3 — informal sub-account

This example considers the issue of whether informal separation would be sufficient to constitute segregation. The facts of the example is that a member elects to be paid a pension after previously being in the accumulation phase and:

The trustees of the fund effectively create an informal sub-account by maintaining accurate accounting records, and are able to identify at any point in time which portion of the bank account balance supports the new superannuation income stream payable by the fund at that time.

Examples 4 and 5 — payments 'in error' into a segregated bank account

Formerly there has been consternation as to whether a segregated bank account that has received an amount either in error or by misfortune that relates to an unsegregated asset, or general fund liability, would immediately cause that account to no longer be segregated. However, this is no longer a cause for concern, provided proper records are maintained and timely action is taken.

Example 4 considers the situation where a fund holds 10,000 shares in a company. Out of those 10,000 shares, 3,000 are held as segregated pension assets and are identified in the fund's accounts as such. The company pays a dividend of \$1 per share and makes a single payment of \$10,000 to the fund's segregated pension bank account. The trustee of the fund 'as soon as practically possible' after receiving the dividend transfers \$7,000 to the unsegregated bank account and an additional \$7, representing the interest component which has accrued in respect of the \$7,000.

Example 5 then considers a situation where a contribution of \$10,000 is credited to an existing segregated current pension asset due to an administrative error. Again in this example, the trustee of the fund realises the error and transfers — or offsets — the \$10,000 plus an amount of \$10 representing the interest earned while in the segregated account to the unsegregated account.

The Commissioner accepts that the bank account will still be a segregated current pension asset in both circumstances. However, the \$7 and \$10 interest component will not form part of any exempt income under s 295-385 ITAA.

Example 6 — incidental payments

The final example involves the trustee of a fund making an incidental payment from a bank account that is a segregated current pension asset in relation to a general fund liability (an annual supervisory levy). The Commissioner accepts that the bank account will still be maintained for the relevant sole purpose and will remain a segregated current pension asset. This example does not provide sufficient background information on whether the fund's two members in pension phase also have accumulation accounts. However, if the fund was entirely in pension mode, an incidental expense such as the fund's supervisory levy, would not jeopardise the segregated status of the bank account.

Examples 4 to 6 show that errors can be corrected and do not upset segregation. However, proper records and timely corrective action is generally needed.



Implications from TD 2014/7

Broadly, the key take away points from the determination is that each of the following will still be segregated current pension assets:

- a separate bank account maintained solely for pension assets;
- a sub-account of a single bank account for the SMSF that is formally maintained by accounting software (and the remaining sub-account for accumulation);
- an informal sub-account that is accurately and appropriately maintained by the trustee; and
- an account that would otherwise be a segregated current pension asset that has received a payment by error or misfortune, which is then off-set or adjusted within a reasonable period of time.

Set off within a reasonable period of time

The logical next question to ask is how long do I have to off-set, adjust or transfer an amount? Or, more specifically, what length of time would be considered reasonable? While there is no direction in TD 2014/7, we consider that 28 days would be 'reasonable'. This was the time period that was considered in the predecessor TD 2013/D7. However, given the final determination is silent, perhaps the ATO is giving taxpayers a little more leeway than just 28 days.

Unsegregated Assets

If it is now so easy to maintain a segregated pension bank account then is there still any reason why you would want to have unsegregated assets?

Why have unsegregated assets?

The short answer is if you want to preserve any capital losses.

If a fund only has segregated pension assets, then all capital gains and capital losses will be disregarded under s 118-320 ITAA. However, if a fund has unsegregated pension assets then any net capital gain is included in the fund's assessable income having regard to the relevant actuarial percentage in accordance with the method statement in s 102-5 ITAA. (The relevant actuarial percentage is, broadly, one minus the percentage of assets funding pensions).

Therefore, a fund with a large capital loss will waste this opportunity if it is completely segregated. However, if it is unsegregated — even by a \$100 contribution, depending on their contribution caps — then the capital loss can be carried forward and potentially utilised in the future.

For completeness, a capital loss that is carried forward may be a valuable asset not only to a member of the fund but also, if structured appropriately, potentially to their dependants who could become members and off-set their future capital gains against any carried forward losses.

Example

Jack's SMSF is in pension mode and is segregated. The assets make a \$100,000 capital loss. Under s 118-320 ITAA, this amount will be disregarded.

Now let's consider the situation where Jack's SMSF is 50% in pension mode and this time the SMSF holds unsegregated pension assets. He makes the same

\$100,000 capital loss in the first year. Under s 102-5 ITAA this capital loss will be carried forward to the next year. In the next year, the SMSF maintains 50% of its assets as unsegregated and the fund derives a \$200,000 capital gain. The assessable income to the SMSF will be:

\$200,000

x 2/3 (ie, the one third reduction that superannuation funds receive)

x 1/2 (ie, the proportion of assets in accumulation mode)

= \$66,667 (ie, the total amount of assessable income to the SMSF for that year of income)

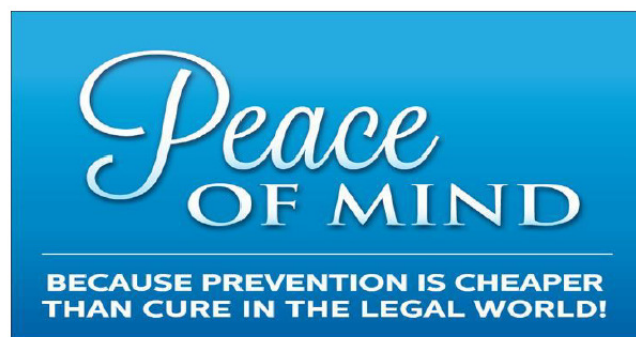
This \$66,667 will be offset by the \$100,000 capital loss from the previous year, leaving \$33,333 as a carried forward loss for the next year.

Therefore, an SMSF can preserve its capital losses by holding unsegregated pension assets. However, the converse is also true. That is to say, if the SMSF starts realising large capital gains, it can switch back to holding segregated pension assets to preserve its capital losses. Otherwise, any capital gains will offset any carried forward capital losses if the fund is unsegregated compared to disregarding any capital gains if the fund is segregated and thereby preserving its capital losses.

Conclusion

TD 2014/7 provides a practical approach to the segregation of pension assets for SMSF trustees. While the determination allows more flexibility as to how bank accounts and term deposits are segregated and maintained, caution still must be exercised by advisers and accountants to ensure that they don't 'throw away' useful capital losses. We also eagerly await the next instalment from the ATO on whether other assets can be segregated in part rather than solely (physically) for pension purposes.

Note: DBA Lawyers hold SMSF CPD training at venues all around Australia and online. For more details or to register, visit www.dbanetwork.com.au or call Marie on 03 9092 9400.



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SMSF Alert

Liam Shorte and Richard Livingston highlight key recent SMSF developments.

By Liam Shorte, Richard Livingston

Key Developments

- Taxpayer Alert on treatment of property profits as capital gains
- Warnings on schemes pitched to SMSFs
- ASIC concerned over unlisted property scheme disclosures
- Tax Office guidance on death benefit dependents
-

The alarm bell has been ringing in recent months, with both the Tax Office and ASIC making announcements warning investors about schemes and investments. Property has been an area of focus.

Let's take a look at the key developments.

Taxpayer Alert 2014/1

The Tax Office [issued a new taxpayer alert](#) warning investors in property development vehicles they may not be entitled to treat their profits as capital gains (costing them the CGT discount).

It's not specifically related to SMSFs, but it could have application to investments made by SMSFs in unit trusts that acquire land (or any other asset) with a view to re-selling down the track at a profit. That's the case even where the property is held for more than 12 months. Broadly, there are three ways an investment might be treated by the Tax Office:

- As trading stock – for assets used in the course of a business (unlikely to be relevant to SMSFs), where gains form part of the ordinary business income
- On revenue account – assets acquired for resale at a profit, where the gain is treated as ordinary income
- On capital account – long term income producing assets, where the gain is treated as a capital gain (and entitled to the CGT concession)

If you're acquiring an investment – and you want to get the CGT discount – it's important to be able to demonstrate you fall into the last category.

Pension mode super funds don't have to worry about the distinction, under current laws at least, because they're exempt from tax on everything.

Warning on SMSF schemes

The Tax Office have identified a scheme involving the purchase of residential property by a unit trust, effectively financed by an SMSF but leased to related parties of the members.

[Speaking at a recent SMSF conference](#), Assistant Commissioner Matt Bambrick pointed out that the scheme could give rise to a number of breaches of the [SIS Act](#).

Mr Bambrick also warned SMSF trustees about participating in schemes involving overseas seminars and stripping franked dividends out of private companies. If you're ever considering an SMSF scheme, keep in mind that many of them probably don't work and rely more on the Tax Office not finding out about them. Unfortunately, SMSFs are a focus area, so they probably will and you'll pay the price.

Unlisted property scheme disclosure

Continuing with the property theme, [ASIC has announced the results of a review into disclosures](#) by the unlisted property sector. They found that some funds were failing to adequately disclose risks against benchmarks established in 2012.

The warning serves as another reminder that you need to research these types of investments very thoroughly. You can't expect that promoters will disclose risks in a user-friendly manner.

Tax office decision on death benefit dependents

Getting away from property, the Tax Office have issued an [Interpretive Decision \(ATO ID 2014/22\)](#) which confirmed that an adult child of a deceased super fund member can be a 'death benefits dependent', allowing them to receive death benefit payments tax-free. A normal 'child dependent' needs to be under the age of 18 years, but the Tax Office took the view in this case that the child qualified under one of the other tests – a 'dependent of the deceased person' – due to the care they provided to the parent and the financial support given by the parent to the child.

Other recent developments

Members may also be interested in the following:

1. *Tax Office decision on loans by SMSFs to property trusts* - The Tax Office issued [Interpretive Decision ATO ID 2014/23](#) which gives an example of when a loan by a SMSF to a unit trust to fund a property purchase would not be treated as an 'in-house asset' of the fund.
2. *ATO has now released 2 new educational videos* - As part of their ongoing education program for SMSF Trustees, the ATO have added two new videos to their YouTube channel: [SMSF paying an income stream](#) and [SMSF planning for the unexpected \(relationship breakdown, incapacity, death\)](#).
3. *Esuperfund fined by ASIC* - The SMSF administrator [Esuperfund](#) was [fined by ASIC](#) for false or misleading online advertising.

Note: Liam Shorte is an SMSF Specialist Advisor™ with [Verante Financial Planning](#) and author of [The SMSF Coach](#). Liam is an Authorised Representative of Genesys Wealth Advisers Limited, AFSL No 232686, ABN 20 060 778 2156.

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