

Heffron Super News



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In this issue:

TR 2009/D3 – superannuation contributions. What does this new draft ruling tell us?

TR 2009/D3 - What is it?

TR 2009/D3 is a tax ruling (draft at this stage), which covers a range of issues relating to superannuation contributions.

It considers, for example:

- What is a superannuation contribution?
- How can a contribution be made?
- When is it received by the Fund?
- And a range of specific issues relating to claiming tax deductions for superannuation contributions.

As this ruling is a draft, it will undoubtedly see some change between now and the final version. Ultimately, however, we believe it will be one of the key rulings relied upon by SMSF practitioners and we have therefore devoted this edition of Heffron Super News to exploring some of the key points it makes.

What is a contribution?

Does this sound like a trick question? In fact, it's a logical place to start as it allows the ATO to establish a general principle: a contribution is any amount that increases the capital of the fund other than:

- Investment income (including capital gains); and
- Insurance proceeds.

Rollovers, transfers from foreign superannuation funds and directed termination payments¹ are contributions – they just have special rules attached. This is why the normal rules on accepting contributions (ie, work tests for the over 65s) are applied to transfers from foreign funds and directed termination payments.

That general principle also means that several other transactions would be treated as contributions:

- The payment of expenses on behalf of the fund (unless that

payment is subsequently reimbursed by the Fund);

- Increasing or improving the rights attached to one of the superannuation fund's investments (eg adding new rights to an existing parcel of shares);
- Making improvements to an asset (such as developing a property) for less than market value consideration;
- Forgiving a debt of the superannuation fund. For example, imagine the superannuation fund borrowed money from a member under an instalment warrant arrangement and was later unable to repay that debt in line with the arrangement. Under normal circumstances, the fund would then hand over the asset to the lender (the member in this instance). If instead the member simply forgave what remained of the debt, this would be a contribution; and
- The same logic applies if the Fund has borrowed from an external party but the member (or some other person / entity)

¹ These are termination payments made by employers that are rolled over to superannuation (only possible under specific circumstances before 30 June 2012).

Heffron Super News

has provided a guarantee for the loan. If that guarantee is called upon (because the Fund cannot pay the debt) and the guarantor does not recover this amount from the Fund, it will be a contribution².

How can a contribution be made?

It is a long established principle that contributions can generally be made in cash, cash equivalent or by transferring ownership of an asset (subject to some restrictions where the asset is being “contributed” by a related party).

Contributions made by cash are only “made” if the cheque is honoured. Where the cheque bounces, the contribution is considered not to have been made.

In the lead up to 30 June 2007, there was a great deal of discussion and speculation as to how one might use promissory notes to make large contributions for those who didn’t hold enough cash to do so directly.

² An interesting side issue here – the ATO has previously expressed concern about personal guarantees for superannuation fund borrowing arrangements. The inclusion of these comments in the ruling suggests that they have either relaxed their position or simply accepted personal guarantees are common in the market place!

(A promissory note is specifically included as money or money equivalent.)

The ruling confirms that promissory notes could well be an effective means of contributing but provides the following cautionary advice:

- An “investment-related” promissory note is considered an asset rather than money. This is perhaps best explained using an example. If Member A writes a promissory note (effectively an IOU) to his own superannuation fund, the transaction is a cash contribution. If, however, Member A acquires a promissory note (say a commercial note or one issued to him by Individual B) and then contributes that note to his superannuation fund, the note is an *asset* not money. The distinction is important because the Superannuation Industry (Supervision) Act 1993 prohibits superannuation funds from acquiring a range of assets from members and would prevent the acquisition of a promissory note in this way; and
- There are also significant implications for the *timing* of the contribution if the promissory note is not presented promptly upon demand.

When is a contribution made?

One of the most valuable sections of the ruling for practitioners is the guidance provided on timing – ie, when is a contribution made?

This is an issue we discussed in our last edition (Issue #63 – 30 June 2009 approaches) as it is naturally extremely important around the end of the financial year.

The date on which the contribution occurs drives a number of important tax events:

- The year in which the contribution is included in the Fund’s assessable income (if applicable);
- The year in which the contributor can claim a deduction (if applicable);
- Providing the contribution is immediately allocated to a member, the year in which the contribution counts for the contribution limits; and
- The date on which the market value of the asset needs to be determined (in the case of an in-specie transfer).

The ruling indicates that the timing of the contribution depends on its nature:

- In the case of electronic transfers between different financial institutions – generally, when the amount is

Heffron Super News

shown on the Fund's bank statement. The draft ruling does soften this somewhat where the transaction is between (say) linked accounts held by a member (the contributor) and their self managed superannuation fund with the same institution. If those transactions can effectively be immediate (ie the superannuation fund has access to the money as soon as the transfer is executed by the member) the contribution will be received on the date the member carries out the electronic transfer even though the fund's bank statement may show a later date (generally the next business day). The trustee and member would need to be sure they held appropriate records to support this if the date was important!

- In the case of a cheque – as soon as the cheque is held by the trustee³ unless it is subsequently dishonoured. Note that the cheque does not have to have been cashed or even presented. This is quite different to the rules which apply for benefit payments. According to an old APRA

³ Note that this assumes the cheque is not post-dated. If it is post-dated, it is not received until at least the date on the cheque.

Circular (I.C.2) a benefit is “cashed” when the cheque is actually banked;

- In the case of promissory notes – as soon as the promissory note is held by the trustee, as long as it is payable on demand. (If it is payable at some future date, it is that date which applies.) A cautionary note for both promissory notes and cheques from related parties – the Commissioner has indicated that this treatment will only apply if the instrument is presented and cashed promptly. In particular, Paragraph 151 states “Presentation of a related party cheque or demand for payment of a related party promissory note will be accepted as prompt if it occurs within a few business days consistent with prudent banking practice”. Otherwise, the cheque or note will be considered to have been “received” (and therefore contributed) when it is actually cashed;
- In the case of shares – when beneficial ownership passes to the superannuation fund. Importantly, the ATO interprets this as including the date on which the fund trustee **receives a properly completed** off-market transfer form. (There was previously

some suggestion that the contribution would not be received until the transfer was actually **processed** by the registry.) Note that this does not give the green light to backdate standard transfer forms! Rather, there is quite a specific requirement that the trustee holds the forms – ie, the contributor can no longer stop the transaction occurring. This suggests that it would be sound practice for trustees to not only keep copies of the (dated) transfer forms but also to keep minutes recording the date on which those forms were received; and

- In the case of property – generally settlement.

So in the case of fairly straightforward transfers or money, which is best - a cheque or bank transfer?

The above treatment suggests that in some cases where :

- the transfer is between different financial institutions; and
- occurs towards the end of the year

a cheque may actually be preferable for a SMSF in terms of certainty as to the timing of the contribution!

Heffron Super News

What if the contribution is initially held in a reserve and allocated in the following financial year?

This issue was not discussed in the draft ruling but was considered by the ATO at a recent NTLG meeting.

Under these circumstances, the contribution is still received by the fund at the time determined above but it is not treated as belonging to the member (say for contribution cap purposes) until it is actually allocated to their account. This may well be in the following financial year⁴.

However, the analysis in the draft ruling will still govern issues that depend on when the contribution is received by the Fund - for example, the year in which it is included in the Fund's taxable income.

Deducting contributions

The ruling also provides some useful guidance on when an individual may claim a personal tax deduction for their contributions.

⁴ Contributions passing through a reserve in this way must be allocated within 28 days of the end of the month in which they are received

We will cover these in a future edition of Heffron Super News as the current draft has not been updated to reflect the recent changes to the 10% test (see Issue #60 of Heffron Super News) and is hence already out of date.

Watch the timing of s290-170 notices

Readers may feel this is a somewhat esoteric issue that is only relevant for fund administrators – given our focus on dotting i's, crossing t's and creating paperwork.

However, the ruling highlights one very important interpretation adopted by the ATO which will have a significant impact on those who make contributions for which they claim a personal tax deduction and who start a superannuation income stream (pension) or transfer / pay some or all of their benefit from the Fund.

Those who wish to claim a personal tax deduction for their contributions must provide a notice to the trustee under Section 290-170 of the Income Tax Assessment Act 1997⁵.

Under normal circumstances, clients have until they lodge their personal tax returns to provide

⁵ The trustee must also acknowledge this notice.

this notice. However, the situation changes if they:

- withdraw or rollover the contributions; or
- start a pension from the account balance which contains the contributions.

If we start with those commencing pensions, the draft ruling indicates that if the pension commences from the "superannuation interest" to which the contributions were made, the notice must be lodged before the pension starts. Note that this applies even if the pension starts with only part of the balance.

Consider the following example based on the principles set out in the ruling:

Example: A member has a superannuation balance of \$150,000 (let's say it consists entirely of a taxable component for the time being) at 1 July 2009.

She makes a personal contribution of \$25,000 in April 2010 and starts a pension with just \$150,000 (ie excluding her new contribution) on 1 July 2010. In May 2011 she prepares her personal tax return and decides to claim a deduction for the \$25,000 contribution.

If the member now lodges a notice under s 290-170 in May 2011, is there a problem? Will the notice be valid?

Heffron Super News

The Income Tax Assessment Act 1997 provides that this notice will be invalid if the member has “begun to pay a superannuation income stream based in whole or in part on the contribution”. At first glance, the member in this example doesn’t have a problem – while she has started a pension, she started it with her original \$150,000 balance and specifically excluded the new contribution.

However, the draft ruling indicates that the ATO interprets this differently. Because the pension started from the “interest” that contained the contribution, they consider that the pension is “based in whole or in part” on the contribution!

As a result, the s 290-170 notice would be invalid and she would be denied the tax deduction.

Whilst that interpretation may appear unreasonably harsh at first, it is actually entirely logical and perhaps the only sensible way to approach the situation.

This is largely thanks to the proportioning rules.

Let’s look at the chain of events in our example in the context of those rules:

- at 1 July 2009, the balance consisted entirely of a taxable component;
- at the time the pension commenced, the balance was \$175,000 (ignoring earnings

on the original \$150,000 for a moment). What are the tax components of this amount?

- in the absence of a notice under s 290-170, the \$25,000 contribution is a non-concessional contribution. Hence \$25,000 (or 14.29%) of the \$175,000 balance is a tax free component;
- Consequently the pension (starting at \$150,000) is 14.29% tax free – its tax components must be set in the same proportion as the overall balance;
- The amount remaining in accumulation phase (\$25,000) includes a tax free component of \$3,573 (14.29%) and a taxable component of \$21,427; and
- If a notice is now received in relation to the \$25,000 contribution, this would change the tax components of both the pension and the amount remaining in accumulation phase. How – in practice – would we deal with it if the notice was valid? It would really mean that we would need to go back to 1 July 2010 (when the pension started) and reclassify the entire amount as a taxable component.

This problem did not arise under the old legislation because there

was no requirement to apply the proportioning rules.

Members could choose to simply leave the contribution accumulating when they started a pension. Importantly, its tax status had no impact on the tax components of the pension and starting a pension had no impact on the tax components of the amount remaining in accumulation phase.

Logically, exactly the same problem should arise if the client withdrew the \$150,000 in cash or rolled it over to another fund.

Curiously, however, the law uses slightly different wording under these circumstances. The Explanatory Memorandum to the original bill also provides an example which explains how the law is intended to work. Both suggest completely different treatment for clients who withdraw / rollover part of their balance rather than starting an income stream.

In a nutshell, if the client in our example had cashed out or rolled over the \$150,000 but still retained \$25,000 in his or her accumulation account at May 2011, the notice would still be valid⁶!

⁶ Albeit the draft ruling provides that if the accumulation balance has fallen to \$20,000 by May 2011 (when the notice is lodged), only \$20,000 could be claimed.

Heffron Super News

This obviously presents significant practical challenges.

For example, after the \$150,000 had been withdrawn or rolled over, our \$25,000 balance had a tax free component of only \$3,573.

Lodging a valid s 290-170 notice for \$25,000 would ordinarily convert \$25,000 from a tax free component to a taxable component. In this example, the tax free component simply isn't large enough to do this.

In effect this means that the member has received a higher tax free amount in the \$150,000 withdrawal than they really should have.

Our general advice to clients who intend to start superannuation pensions or cash / rollover any part of their balance would be to provide the s 290-170 notice to the trustee **first!**

2009 Advanced SMSF Training

If you would like to attend our Advanced SMSF Training this year please go to our website (www.heffron.com.au) to download the invitation or contact us for further information.

Venues for September include Brisbane, Sydney, Hunter Valley, Launceston, Melbourne and Perth.

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