Keeping track of superannuation interest is critical

Graeme Colley

A 'superannuation interest' is something that is unique to SMSFs and some government superannuation funds. Keeping track of each superannuation interest may be a nightmare for some accountants, financial planners and true DIY clients, and failure to do the right thing may lead to catastrophe for the client or their dependants.

A review of what is meant by 'superannuation interest' in the income tax law may seem trite. Not getting it right in the first place or getting it wrong due to ignorance could end in tragedy for a client or beneficiaries on the client's death. The mess that can be created by some 'SMSF professionals' in working out a client's superannuation interest can be impossible to unwind due to a lack of supporting evidence and result in an inequitable taxation outcome for the client.

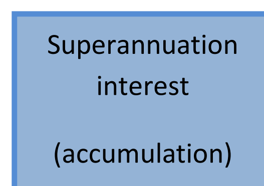
A 'superannuation interest' is a concept invented for purposes of the income tax legislation as it identifies solely the taxation components of a member's accumulation and pension benefits. in an SMSF and also a public sector fund. The legislation does not apply to other types of funds such as industry, retail or corporate, however, the regulators expect those funds to follow the principles of the legislation. I understand that many APRA funds do not retain or record the taxable and tax free components of superannuation interests once a member reaches age 60. Also, it is important to note superannuation interest has no relevance in determining the preserved components of a member's benefit. In this article I will limit the discussion to superannuation interests in SMSFs.

The general rule is that a members' superannuation interest in an SMSF is that a member has one only superannuation interest. However, the exception to the general rule is that each pension account of a member has its own superannuation interest. It is therefore possible for a member to have superannuation interests supporting amounts in accumulation phase and a number of other superannuation interests, each supporting its own pension interest. What is meant by a superannuation interest is found in the Income Tax Assessment Act 1997 (ITAA '97) in Subdivision 307-D (s 307-200), the definition in s995-1(1) and the Income Tax Assessment Regulations 1997 (reg 307-200).

Retaining and recording the tax free amounts in an SMSF after a member reaches age 60 may seem a pointless exercise as any lump sum or pension payment from the SMSF will be tax free to the member, their spouse and other dependants for tax purposes. If the ultimate benefit paid on the member's death is to be paid to a non-dependant and taxed in their hands the taxable and tax free components are essential. The calculation may also have a bearing on certain death benefit pensions received by a surviving spouse who may be able to commute and rollover their spouse's death benefit in very limited circumstances.

Let's start considering superannuation interests and look at a simple example, then move to more complex situations, particularly those where a surviving member may be in receipt of a death benefit pension.

Superannuation interest – one account only



The most common situation where a person will have one account in an SMSF is during the accumulation phase or after retirement when the member may have no need for the amount in super. During these stages it is necessary to ensure that the fund records the tax free component

of the interest. There is no need to record the taxable component because s 307-215 of the ITAA '97 calculates the taxable component as the value of each superannuation interest less its tax free component. Any amounts credited to the member's account such as income, contributions and expenses should be recorded as required by the fund's trust deed.

The definition of the tax free and taxable components of a member's superannuation interest is found in s 995-1(1). While the definition refers to the provisions of sections 82- 40, 307-120 and 307-210 it is the provisions of s 307-210 which are the most relevant in making the calculation. Section 307-210 determines the tax free component as the 'contributions segment of the interest' plus the 'crystallised segment of the interest' which are explained later. The definition of taxable component in s 995-1(1) has a similar approach, however, refers to sections 82-145, 307-120 and s 307-215.

The 'contributions segment' is defined in s 307-220 and is basically the sum of amounts that have not been included in the taxable income of any fund. This would include non-concessional contributions, spouse contributions, child contributions, the government co-contribution and the low income superannuation contribution. The crystallised segment is defined in s 307-225 and was determined as far back as 30 June 2007 for anyone who had a balance in a superannuation fund at that time. The fund may have a record of the crystallised segment, however, in most cases it is usual that this has been aggregated in the tax free component of the superannuation interest.

As an example of calculating the tax free component, let's assume Almira has an account in an SMSF and been contributing from her after tax savings for many years. In addition, her partner, Arthur, has made spouse contributions for her and she has also received the co-contribution on a number of occasions. The total of these amounts is $140,000. The value of Almira's benefit in the SMSF is $350,000. Therefore the value of Almira's tax free component is $140,000 and the value of her taxable component is $210,000 ($350,000 - $140,000).

When drawing benefits from a member's superannuation interest the tax free and taxable components are calculated by using the proportioning rule. This rule operates prior to the trustees paying a lump sum from a member's accumulation interest or prior to the commencement of a superannuation income stream. If the superannuation income stream is commuted to a lump sum it will use the same proportions that were calculated at the time the income stream commenced.

The proportioning rule calculates the tax free and taxable components as a proportion of the total account balance immediately prior to a member receiving the lump sum or income stream. It is interesting to note that the legislation does not set the valuation method to be used, however, the ATO consider that for these purposes the market value of assets as published in their valuation guidelines should be used.

If we were to use Almira's case above, 40% of her superannuation interest ($140k/$350k) consists of a tax free component and the remainder consists of a taxable component, that is, 60% ($210k/$350k). If she were to draw part of her superannuation interest as a lump sum the tax free and taxable components would be split into the 40%/60% proportions. If Almira's superannuation interest was used to commence a superannuation income stream the taxable and tax free amounts of each income stream payment and any lump sum commuted from it would consist of the same proportions that were calculated at the time the income stream commenced.

The ITAA '97 envisages that a member may have more than one accumulation interest in the fund and no pension interest. This is extremely rare and possibly non-existent in the case of SMSFs and may be more relevant to public sector funds, the other category of fund to which the legislation applies.

Superannuation Interest – two accounts

Superannuation interest (accumulation)	Superannuation interest (income stream)

A member may have more than one superannuation interest with some of their super and commence a superannuation income stream with some of the accumulation balance. The amount remaining in the accumulation interest will be one superannuation interest and the amount that provides the superannuation income stream will be another superannuation interest.

As an example, let's assume Bjoern's superannuation interest in accumulation phase had a balance of $500,000 and included a tax free component of $100,000. If he commenced an account based income stream with $400,000 the proportioning rule would be used prior to the commencement of the income stream to work out the tax free and taxable components. Prior to transferring the amount from the accumulation account to the income stream account the proportion would be $100,000/$500,000 consisting of a 20% tax free component and an 80% taxable component. Once the income stream commences the proportions stay with the income stream balance until it ceases. Therefore any amount received as an income stream or any lump sum received from the part or full commutation of the income stream will include the tax free and taxable components as determined when the income stream commenced.

In cases where the income stream has commenced solely from a tax free component it will always be tax free including income that is accumulated on the tax free amount. As an example, Anna commences an SMSF with a non-concessional contribution of $540,000 which will be her superannuation interest. On the same day as the non-concessional contribution has been made she commences a superannuation income stream with the whole balance of her superannuation interest. The income stream, immediately prior to commencement, will consist wholly of a tax free component and therefore any income stream payments and lump sum withdrawals including earnings credited to the account will also be tax free. This may be a useful strategy in many circumstances, for example, in the case of structured settlements or orders for personal injury where the amount transferred to the fund consists wholly of a tax free component.

Careful management of a person's superannuation interests in both the accumulation and income stream phases can maximise the tax free components of any superannuation income stream similar to the result achieved in Anna's example. In addition, where a member meets a condition of release and is able to access the recontribution strategy it may be possible to convert taxable components into tax free components. This can be achieved by the withdrawal of a lump sum from a superannuation interest which includes a taxable component and recontributing the amount as a non-concessional contribution, subject to the non-concessional cap rules.

Superannuation interest – three accounts

Superannuation Interest 1 Accumulation	Superannuation Interest 2 Account based pension	Superannuation Interest 3 Account based pension

There is no limit to the number of superannuation interests a member may have in an SMSF. However, the use of multiple accounts needs to take into account the purpose for which each superannuation interest is maintained and the costs associated with their administration.

The calculation of the tax free and taxable components in the case of multiple superannuation interests is no different to the examples above where two accounts were involved. The only exception is that there are a greater number of superannuation interests for which information must be maintained.

Let's assume Fleur, age 61, has an SMSF and has three superannuation interests in the fund. These consist of a superannuation interest in accumulation phase and two superannuation interests in pension phase. The components of each superannuation interest are:

	Superannuation Interest 1 Accumulation	Superannuation Interest 2 Account based pension	Superannuation Interest 3 Account based pension
Tax free component	$100,000	$500,000	$200,000
Taxable component	$50,000		$300,000
Total balance	$150,000	$500,000	$500,000

Fleur is a member of another fund and just before retiring at age 63 she would like to consolidate that benefit into her SMSF. The balance in the other fund is $100,000 and consists wholly of a taxable component. The two pensions she is currently receiving are transition to retirement income streams as she hasn't met a condition of release where there are no conditions to the type of benefit payable.

From an estate planning point it may be worthwhile for Fleur, rather than rollover her benefit to the SMSF receive it as a lump sum if she meets a condition of release. That amount can then be made as a non-concessional contribution to the fund and would form part of her tax free component.

If the rollover benefit consists wholly of a preserved component the amount would be added to Fleur's accumulation balance. She then may wish to draw a third pension from the fund with the increased balance or wait until a condition of release has been met, such as retirement when she reaches age 63.

Once Fleur has retired permanently at 63 and does not intend to return to work for more than 10 hours each week she may wish to draw a lump sum from the accumulation account and then recontribute it as a non-concessional contribution. Another option may be to commute the pension which has a taxable component and then recontribute it as a non-concessional contribution. If her account balance in accumulation phase then consists wholly of a tax free amount because of the manner in which non-concessional contributions have been made to the account then the whole account could be used to commence an income stream consisting wholly of a tax free component.

The advantage of this strategy for estate planning purposes is that, depending on which strategy is used, Fleur may end up with account based income streams consisting of a 100% tax free proportion. On Fleur's death if non-dependant children for income tax purposes, that is, children of the deceased older than 18, receive a lump sum from income streams that have a 100% tax free proportion the whole amount they receive will be also be tax free.

In some cases accountants and financial advisers think that the process of converting taxable components of an income stream to tax free components can be achieved by a series of bookkeeping entries without any payment actually leaving the fund. This is incorrect as commuting the income stream as one superannuation interest and treating the lump sum as if it had been paid will retain the same tax free and taxable proportions as the original pension from which the commutation was made. Once the pension is commuted and not paid from the fund it

will be combined with the accumulation interests to determine the tax free component of the combined interest.

By correctly paying the amount from the fund the tax free and taxable components will lose their identity after they have been received by the member. If the member then decides to recontribute the amounts received back to the fund as non-concessional contributions they will be added to the accumulation account of the member as tax free amounts. If possible the income stream should commence with the 100% component in the accumulation account prior to the allocation of any income or transfers from reserves that may be treated as concessional contributions if they exceed the limits specified in regulation 292-25.01 of the Income Tax Assessment Regulations 1997 (ITAR 1997).

Death Benefit Pensions

Superannuation interest (accumulation)	Superannuation interest Account based income stream	Superannuation pension interest Death benefit income stream

On the death of a member a pension may commence to be paid or continue as a reversionary pension to a surviving dependant. In both of these situations a separate account must be established in the name of the survivor who will now be a member of the fund and is required to be appointed as a trustee or a director of the corporate trustee of the SMSF if they are not already at the time of death.

The reason to keep the death benefit superannuation pension interest separate is to ensure the tax free and taxable components of the deceased are retained. In addition, it is not possible to 'mix' the balance of any death benefit pension with other superannuation interests, even other death benefit pension interests as it results in the commutation of a death benefit which must be paid from the fund as a lump sum. If the dependant wishes to commute the death benefit pension to a lump sum, the provisions of Reg 1.07 of the SIS regulations must be met and an election under reg 995-1.03 of ITAR 1997 will be required. Any death benefits that are commuted must be paid out of the fund to the member except in the event of their death when the amount can be paid to their dependants.

There is only one exception to the requirement that death benefits must be paid from the fund and are able to be retained in the fund or rolled over. This occurs in the case of a pension which was being paid to the deceased at the date of death and became payable to surviving spouse. In these cases the spouse is able to commute the pension and roll it over to another fund or to another superannuation interest after the death benefit period in 307-5(1) has been satisfied. That amount will be held in the spouse's accumulation superannuation interest rather than a new superannuation death benefit interest established in the receiving fund or as a result of an internal rollover in terms of section 307-5 of the ITAA 97.

Taking an interest in a client's 'superannuation interest' is essential as part of a professional service to a client or their dependants. By not taking an interest in the 'interest' a client and possibly their dependants could be exposed to paying more tax than they are required to. As the late Kerry Packer once famously said, "Pay your taxes, just don't tip them. They're not doing that good a job."

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