

## Pensions available from a SMSF

The two main types of pensions that can be commenced from a Self Managed Superannuation Fund (SMSF) are the *Account Based Pension* for those who have retired and the *Transition to Retirement Income Stream* (more commonly known as a Transition to Retirement Pension) for those still working.

The major difference between these two types of pensions is the more stringent rules surrounding when you can commute or withdraw either some or all of a Transition to Retirement Pension as a lump sum.

Both these types of pensions were introduced with the Simpler Super changes from July 2007. To permit the payment of these pensions the SMSF Trust Deed may require updating if the deed has not been updated for the Simpler Super changes.

### The Account Based Pension

An Account Based Pension provides a tax-effective and flexible retirement income stream for superannuation savings. They provide full access to capital and are the most popular retirement income stream product in Australia.

Generally, retirees aged 55 or more can commence an Account Based Pension. An Account Based Pension has no tax on investment earnings and has significant tax concessions on the income stream payments (tax free for those aged 60 or more).

An Account Based Pension can be commenced where a member:

- has reached preservation age (currently age 55), and has retired from the workforce. *However, if they have reached preservation age and continue working, they will need to commence a Transition to Retirement Pension.*
- is aged 60 or more and have ceased employment.
- has reached age 65 (whether you are working or not).
- has retired early due to disablement or invalidity.

An SMSF member can commence a pension with all or only part of the super monies they have in their fund. Once established no further superannuation monies can be added to an account based pension.

However, this does not prohibit a second pension being commenced at a later date from any remaining accumulation monies or later contributions, or an existing pension being commuted back to accumulation (provided minimum payment requirements have been met) with a new pension commenced with a member's entire balance.

### Minimum Pension Payments and Special Relief for 2010 Financial Years

Each year the level of pension payments must meet at least the minimum thresholds which are determined by age and account balance on the commencement of the pension and thereafter on 1 July each year.

These levels are outlined in the table on this page. The table also shows the required minimum pension for each \$100,000 of an account balance. The table also illustrates the 50% reduction in the minimum pension level that applies for the 2009-10 financial year and previously.

Age	All Financial years except 2009-10 & 2008-09		Special Minimum Limits 2009-10 & 2008-09 Financial years only	
	Minimum payment as % of account balance	Annual Pension Level for each \$100,000	Minimum payment as % of account balance	Annual Pension Level for each \$100,000
55 - 64	4 %	\$4,000	2 %	\$2,000
65 - 74	5 %	\$5,000	2.5 %	\$2,500
75 - 79	6 %	\$6,000	3 %	\$3,000
80 - 84	7 %	\$7,000	3.5 %	\$3,500
85 - 89	9 %	\$9,000	4.5 %	\$4,500
90 - 94	11 %	\$11,000	5.5 %	\$5,500
95+	14 %	\$14,000	7 %	\$7,000

If the pension commences on or after 1 June then no minimum payment amount is required to be paid in that financial year. When a pension starts on a day other than 1 July, the pension limit and the annual pension amount will be calculated on the number of days the pension has to run during the remainder of the first financial year.

### Maximum Pension

There is no limit on the maximum amount that can be withdrawn from an Account Based Pension (*except for the Transition to Retirement Pension outlined below*), so if required it is possible to withdraw the whole amount. Payments will be made until the balance in pension account has been completely withdrawn.

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## Maximum Pension (cont'd)

An Account Based Pension may not provide a pension for the rest of an individual's life with its longevity depending on a number of factors such as the level of pension being drawn down, the performance of the underlying investments and the number of lump sum withdrawals (commutations) taken out of the pension (if any).

## Transition to Retirement Pension

If a person has reached preservation age (currently age 55) but is still working, they cannot establish the Account Based Pension as outlined earlier. However they can start drawing down a pension from their SMSF by instead establishing a Transition to Retirement Pension. Both types of pensions are very similar products and, most importantly, share the same tax benefits.

However a Transition to Retirement Pension is different in that:

- Lump sum withdrawals (commutations) are *not allowed*; and
- Pension payments are subject to a maximum withdrawal of 10% of the account balance each year (calculated on the 1 July balance). In the first year the 10% limit is not pro-rated and is calculated on the account balance on the commencement day.

Although the ability to commute is limited, funds may still be rolled back into accumulation at any time.

When any of the following occur, a Transition to Retirement Pension converts to a standard Account Based Pension, after which lump sum withdrawals are allowed and no maximum pension limits apply. The pensioner:

- Permanently retires.
- Is aged 60 or more and employment terminates.
- Attains age 65.
- Becomes permanently incapacitated.

A Transition to Retirement Pension may suit someone who wishes to increase their level of income in addition to their salary, to reduce their overall level of tax by structuring their income sources more effectively (eg in conjunction with salary sacrifice contributions) or to reduce their working hours but not their income.

## Transition to Retirement and Salary Sacrifice

The combination of a tax effective Transition to Retirement Pension and concessional salary sacrifice contributions may enable a member to reduce their level of income tax but not the level of income. The viability of this strategy depends on many issues including age, income requirements, level of salary, ability to salary sacrifice and a member's superannuation components.

## Tax Benefits of SMSF Pensions

### Taxation of the Fund

Once a pension has commenced no tax applies on investment earnings of the assets supporting the pension. In addition any applicable franking credits received will be refunded by the ATO to the SMSF. Where a fund has a mix of accumulation members and pension members it may be necessary to obtain actuarial certification to determine the applicable level of exempt pension income.

Due to the investment earnings on pension assets being exempt from tax consideration should be given to crystallising any significant capital gains whilst in pension mode as the gains would be tax exempt.

This may reduce the tax burden on any death benefits, as where assets are sold to pay a lump sum benefit after the death of the last pensioner capital gains would be payable.

### Taxation of the Pensioner

For individuals aged 60 and over the pension payments are tax free.

For individuals aged under 60 it is more complex as any pension may have:

- a tax free component which will be received tax-free
- a taxable component which will be taxed at marginal rates. In addition a 15% tax rebate will apply to the taxable amount of the income stream.

The tax-free component is calculated according to the tax-free percentage that applies to your account. This tax-free percentage is calculated when a pension is commenced and applies to every pension and lump sum payment (commutation) you receive from your pension account. This percentage is fixed for the life of the pension.

The tax-free component is made up of a 'contributions' segment and a 'crystallised' segment.

Generally, the 'contributions' segment is made up of contributions made from 1 July 2007 which have not been subject to tax in the Fund. Typically, this would comprise your non-concessional (after-tax) contributions and any Government co-contribution. The 'crystallised segment' is made up of the concessional tax components that existed before the Super Simplification reforms took effect on 1 July 2007. Most commonly this amount will consist of the pre-July 83 component and undeducted contributions (since 1 July 1983) that were applicable as at 30 June 2007.

The taxable component of a pension is calculated by subtracting the tax-free component from the total value of your superannuation benefit.

The taxation of a pension paid as a reversionary pension (see section below) after the death of the original pensioner will depend on the age of the primary and reversionary beneficiary. If the primary beneficiary was aged 60 or over at the time of death, then payments to the reversionary beneficiary will be tax exempt. If the primary beneficiary was under age 60 at the time of death, the taxable component of the pension (any tax free proportion is excluded) will be taxed at the reversionary beneficiary's marginal tax rate (less pension rebate) unless, or until, the reversionary beneficiary is aged 60 or over, in which case the pension becomes tax exempt.

On the death of the pensioner, for a pension not established as a reversionary pension, it may either be paid as a lump sum to dependants or even continued as a reversionary pension. In this situation the beneficiaries would be in accordance with any binding nomination made by the member or at the trustee's discretion should the nomination not be binding.

A lump sum death benefit payment will be tax free if paid to a person who is a dependant. If the lump sum death benefit is paid to a non-dependant, any taxable component of the benefit will be taxed at 15% plus the medicare levy. The taxable and tax free components will be calculated based on the percentages calculated when the pension was established.

### Advice Required

As with any financial investment, it is very important that before implementing any arrangements, you consider seeking financial advice to ascertain whether an account based pension or a transition to retirement strategy will benefit your situation.

## ATO Releases Final Ruling on Unpaid Trust Distributions

In late June 2009 the Australian Taxation Office (ATO) issued its final ruling on unpaid trust distributions (SMSFR 2009/3). The ruling considers whether an SMSF is contravening the Superannuation Industry (Supervision) Act (SIS) if it is presently entitled to distributions from a related trust but it has not received the payments.

The ruling discusses the most relevant three SIS provisions and identifies the circumstances where a contravention might occur. The provisions are the:

- in-house asset rules
- arm's length rule
- sole purpose test.

### In-house asset rules

The market value of in-house assets that an SMSF may hold is 5% of the market value of its total assets. An 'in-house asset' is any of the following:

- an asset the fund loans to or invests in a related party
- an investment in a related trust
- an asset subject to a lease or lease arrangement between a fund's trustee and a related party of the fund.

The ATO's view is that where an SMSF is entitled to a distribution from a related trust but the related trust has not paid the distribution it would usually be a loan to the trust and thus an in-house asset of the SMSF if the following factors apply:

- the trustees of the fund and the unit trust are the same or under substantially the same control,
- the amount of unpaid trust distribution is substantial,
- the amount has remained unpaid for a substantial period of time, and
- distributions for multiple years remain unpaid.

An SMSF trustee would contravene the in-house asset rules where the unpaid trust distributions included in the in-house assets causes it to exceed the maximum 5% limit.

### Arm's length rule

Where an SMSF holds an investment in a related trust, they must undertake any dealings with the trustee in the same way as they would if that trustee was at arm's length.

The ATO's view is that unpaid distributions will generally result in a breach of the arm's length investment rules where:

- the trustee does not seek payment of substantial trust distributions within a reasonable time, and
- no interest is paid or compensation given in respect of not seeking that payment.

### Sole purpose test

An SMSF's trustee may contravene the sole purpose test if both of the following apply:

- they keep a lot of the SMSF's assets in a related trust as unpaid trust distributions
- they are receiving below market rates or no interest for the unpaid trust distributions.

## ATO Approach

Where the SMSF has entered a contractual loan agreement, the ATO recommends that they support this agreement with a written record showing the terms of the loan. This may include:

- whether the loan is at call
- the amount of the loan
- the interest.

The ATO considers trustees should have prepared this written record by 30 June 2009. However, the ATO will let Trustees formalise the agreement up to the due date of their 2009 annual return where:

- the unit trust had the loan funds on 30 June 2009
- the parties acted according to the agreement.

### Unpaid trust distributions and the in-house asset transitional rules

For funds investing in pre 1999 private unit trusts under the ten year transitional rules that ceased on 30 June 1999, some or all of the unpaid trust distributions from the SMSF's in-house assets may have been excluded from being in-house assets.

The ATO has advised that where an SMSF's trustee entered a contractual agreement where the unpaid trust distributions were paid and lent back to the unit trust on arm's length terms (including interest) before 1 July 2009 the ATO will consider that they have rectified any earlier breaches of the in-house asset rules from accumulating unpaid trust distributions and will take no further action.

## Joint Ventures by SMSFs under ATO Scrutiny

Also in June 2009 the ATO released Taxpayer Alert TA 2009/16 Circumvention of in-house asset rules by self-managed superannuation funds using related party agreements.

Taxpayer Alerts are intended to be an 'early warning' of significant new and emerging higher risk tax planning issues or arrangements that the ATO has under risk assessment.

This ruling describes an arrangement where a SMSF enters into an agreement (sometimes referred to as a joint venture agreement) with a related trust to acquire assets such as rental property in order to obtain certain taxation and superannuation benefits.

The ATO is concerned with the SIS compliance of such arrangements and whether they may be a scheme to circumvent the 5% in-house asset restriction. They may also result in tax avoidance, for example the potential for non arm's length income.

We would recommend that any funds that have undertaken this type of investment seek a legal review of their situation with their advisers.

## AAT Decision Highlights the Need for SMSF Trustees to Keep Finances Separate

A recent decision of the Administrative Appeals Tribunal (AAT) has again highlighted the need for SMSF trustees to keep the finances of their SMSF and business completely separate.

The AAT decision affirmed the ATO's decision to make an SMSF non-compliant because it breached the in-house asset rules by lending fund assets to prop up a family business.

Commencing in the 2005 financial year, loans from the SMSF to the family business totalled \$211,000. While \$75,000 was repaid in the 2005 financial year, the remainder was not repaid until 2008 and 2009 financial years. Interest of 10% was paid and the loan was documented.

The husband and wife trustees appealed the ATO decision, but the AAT found that loans to the husband's company from the SMSF were a serious breach of the super laws, even though the loan was subsequently repaid.

The trustees argued that the loan was to see the company through a difficult period when the company's usual bank refused further finance. They claimed that accessing the loan from the SMSF enabled them to continue trading and that they intended to repay the loan quickly but were unable to do so. The loan was repaid over four years but, during that period, the company made other investments instead of repaying the loan.

Under superannuation law, SMSF trustees must take reasonable steps to ensure that in-house assets do not exceed 5% of the total asset value of the fund. In this case at some points during the loan period, more than 95% of the SMSF's assets were on loan to the husband's company.

The trustees also argued that the husband was suffering from a chronic illness at the time and that the company's premises had sustained damage from cyclones. While the AAT took these factors into account, they were not sufficient to excuse the trustees' actions.

Because the fund did not comply with the in-house assets rules, it lost the advantage of the concessional tax rate of 15% and instead will be liable to pay tax at the highest marginal tax rate of 45%. Under superannuation law, a fund with assets exceeding 5% of total assets invested with a related party can be declared non-compliant and lose the tax concession as a result.

The sole purpose of an SMSF must be to provide retirement income. The concern with related-party arrangements is that they can allow certain parties to take advantage of the fund assets and ultimately put those assets at risk.

## ATO SMSF Compliance Program

The ATO announced in August their compliance program for SMSFs for 2009-10. The compliance program outlines the tax and superannuation compliance risks the ATO is most concerned about and what the ATO is doing to address them.

For SMSFs the ATO will concentrate on regulatory issues such as:

- Loans;
- in-house assets;
- borrowings; and
- non-arm's length transactions.

The ATO will contact over 3,000 trustees of SMSFs to determine their compliance with these issues.

The ATO will also look at:

- the income tax obligations of SMSFs, particularly accuracy and timeliness of lodgements;
- residency requirements for trustees;
- ensuring approved auditors fulfil their role properly;
- illegal early release schemes; and
- lodgement of new registrants and funds that perpetually fail to meet their lodgement obligations.

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