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BEWARE OF THE "USE BY DATE" FOR SMSFS

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Self-managed super funds (SMSF) continue to be one of the fastest growing sectors within the superannuation market. According to recent 2012 Australian Prudential Regulation Authority (APRA) statistics, there are 478,264 funds accounting for 31.3% of the total superannuation market with approximately $1.4 billion invested.

While SMSFs seem to be an attractive sector, the discussion often seems to get sidetracked with fees and the difficulty of managing the relationship with a referral source accountant, rather than focusing on the positive strategic outcomes and benefits and the value proposition this produces for clients over a majority of their accumulation and retirement time cycle. However, there may well come a time when the SMSF reaches its "use by date".

Anti-detriment payments are a case in point. Firstly, anti-detriment is generally poorly understood by most practitioners; secondly they are under utilized; and thirdly their appropriateness for use by a SMSF is generally polarized between two extreme views of "must use" or "impractical to use" due to funding and tax issues.

In this technical review, we would like to explore two key concepts:

- That SMSFs have a "life cycle" with a "use by date" beyond which the client is perhaps better serviced via a retail superannuation wrap; and
- That where this is true, it may be possible to continue the SMSF and actually rejuvenate the SMSF by introducing younger family members such as adult children

This article explores the nature of the SMSF life cycle and how the key differences between retail super wraps and SMSFs can result in the SMSF having a "use by" date. This allows retail superannuation wrap accounts to provide an "end game" solution including the ability to increase member death benefits via anti-detriment payments. We also have a quick look at what anti-detriment payments are and how they are calculated and claimed. Finally, we will look at how this analysis can be used with referral sources (such as accountants) to strengthen and enhance these relationships.

The life cycle of SMSFs

So the first question is when is the right time to move a client into a SMSF – is it $100,000 or $200,000 or $500,000 worth of assets? The actual amount is irrelevant to this discussion. What is important is that before starting a SMSF, there needs to be a reasonable level of assets accumulated and accompanied by the ability to make substantial contributions over time. The obvious vehicle in which to accumulate sufficient assets prior to starting the SMSF is the retail super wrap or its equivalent.

Having accumulated the required assets and being in a position to contribute strongly to super or to make use of the more sophisticated strategies such as those involving business real property or limited recourse borrowing arrangements, a SMSF really comes into its own. It probably remains an appropriate structure for many years – taking clients through the accumulation phase right through to transition to retirement and for a large part of the clients retirement, but there comes a time when the SMSF is no longer the best structure to achieve the client's needs.

Whether this is because of age, diminishing mental capacity, a switch to more income based strategies with no need for sophisticated growth oriented strategies or simply that they no longer want the burden of the trustee obligations and responsibilities, the time will come when the SMSF has reached its 'use by date'.

At that point, provided the investments allow, the client is usually better served by rolling back to a retail super product as this option provides virtually all of the required investment, pension and estate planning features and flexibility of a SMSF without any of the administrative burden or trustee responsibilities.

And if you needed another very strong reason to justify this strategy – it is called the anti-detriment benefit, the extra benefit payable only on death. This is essentially a refund of any contributions tax ever paid by the superannuation fund on the deceased member's contributions over his lifetime. It is a lump sum amount paid in addition to the member's account balance, but it can only be paid where the death benefit is paid as a lump sum to an eligible dependant – spouse, former spouse or child – of the deceased.

What is an anti-detriment benefit?

The concept of anti-detriment benefit was introduced on July 1, 1988 when the 15% upfront contribution tax was put in place, with the idea that the additional amount now payable on top of the members account balance on death represents what the death payment would have been had the contributions tax not been introduced.

Where does the money come from for the fund to pay the additional anti-detriment amount? Under the tax law, payment of an anti-detriment amount by a fund creates a tax deduction for that fund. This tax deduction can be used to offset any assessable income of the fund including capital gains–say on the sale of assets to pay the death benefit – or by new members coming into the fund to offset their contributions tax, or to reduce the funds tax liability on investment earnings and interest. Any excess deduction not used can be carried forward as losses for future use.

This extra payment is funded by the Australian Taxation Office (ATO), but unfortunately can only be claimed through the specific process of calculating the anti-detriment benefit payable and actually making the payment, before recovering it from the ATO through utilizing the tax deduction created by the payment. It is this tax deduction that results in a reduction in the tax expense that funds the anti-detriment payment.

Therefore, if the fund is not able to make the payment in the first instance or is not able to make use of the tax deduction generated, the fund will not be able to effectively claim the benefit on behalf of the member.

Can all funds pay anti-detriment benefit?

Technically, all continuously complying funds are able to pay the benefit. However the legislated mechanism for the payment of the benefit and the claiming of the benefit from the ATO makes it hard for some funds to do so. Following on from this, while it is not impossible for a SMSF to pay an anti-detriment benefit, it can be rather difficult. This is because as we now know, the anti-detriment payment is funded by the ATO through the superannuation fund claiming a tax deduction for the anti-detriment payment made.

This reduces the funds assessable income thereby potentially providing a tax saving equivalent to the anti-detriment payment and it is this tax saving which is effectively reimbursing the fund for the increased member payment. It is this whole process that creates difficulties for SMSFs to make the claim as it is explained below.

The legislated mechanism in detail

A superannuation fund must have the liquidity available to start the process rolling by making the actual payment of the extra benefit. It is important to note that in making the additional benefit payment, other members vested accounts cannot be used to fund the payment. If a payment cannot be made, then the anti-detriment payment can never be recovered from the ATO.

For a SMSF to have sufficient surplus non member liquidity when a payment is needed, a lot of forward planning (and time) is required to create a reserve account (which by definition is not allocated to any members account) to make the payment. Even then, an allocation from a reserve to make that payment may be subject to the deceased member's concessional contribution caps potentially resulting in an excess contributions tax problem.

Furthermore, with a SMSF, there is rarely the opportunity to claim the anti-detriment deduction at the time of death as either there are no more, or very few contributing members, or with the remaining member/s in pension mode the fund has no taxable income or in many cases the fund is due to be wound up. If the tax deduction is not utilized this effectively means that the fund had not been able to recover this extra payment from the ATO.

A retail super fund on the other hand has the capacity to claim the tax deduction immediately due to the on going other members contributions as well as the taxable fund earnings. As there is an immediate reduction on the funds tax liability, it has the ability to make the payment without compromising minimum member benefits and using any reserves. As the payment is coming from a tax saving rather than a reserve account, the anti-detriment payment does not get caught or tested under the deceased member's concessional contribution cap.

How is anti-detriment amount calculated?

The anti-detriment amount is calculated only on the taxable component of the member death benefit excluding any part of the taxable benefit generated from an insurance payment. This makes sense as the idea is to refund any tax that has been paid on the benefit, hence no refund on non concessional contributions which form the tax free component of the payment nor on insurance proceeds which have not suffered any tax.

Thus, a cautionary note for those promoting the use of a re-contribution strategy (where you convert taxable component to tax free component) noting that the strategy actually reduces the level of potential anti-detriment payment. It is therefore crucial to think of anti-detriment alongside the re – contribution strategy – as it is certainly an 'anti anti-detriment' strategy!

There are several different ATO approved methods of calculating the anti-detriment payment. The fund's auditor can certify the actual dollar amount of contributions tax paid on behalf of the member since July 1, 1988, or, the trustee can use one of two ATO approved formula methods that effectively estimate the contributions tax paid.

Given that fund records are rarely sufficiently detailed to allow the auditor to certify the actual contributions tax paid (plus the cost of certification), generally one of the formula is used. The most common one is:

((0.15 x P) / (R – 0.15 x P)) x C

Where:

R is the service period occurring after 30 June 1983
P is the number of days in "R" occurring after 30 June 1988
C is the taxable component of the members benefit excluding any insured amount.

Example:

- John's eligible service date is 1/07/1990
- Date of benefit payment 1/01/2013
- Death benefit $500,000
- Tax free component NIL
- Insurance proceeds NIL
- **R** = ESP after 30/06/1983 8221 days
- **P** = No days in "R" post 30/06/1988 8221 days
  (R = P in this case as John started work after 30/06/1988)
- **C** is the taxable component $500,000

(0.15 x 8221) / (8221 – 0.15 x 8221) x $500,000
(1,233 / 6,988) x $500,000
0.176 x $500,000
$88,235 **Anti-detriment payment**

A tax deduction of $588,233 is available to the fund (and if fully utilized recoups the $88,235 from the ATO)
$88,235 / 0.15 = $588,233

While this sounds complex, the result is that there is the potential for a spouse, former spouse or child of a deceased member who are paid a death benefit lump sum to get the taxable element of that benefit increased by up to 17.6% courtesy of the ATO – in the case of the example above – $88,235!.

SMSF 'use by date'

Thus we have come full circle – start with a retail super fund to accumulate assets – use a SMSF to drive and build retirement assets and eventually funding the anticipated retirement lifestyle. In the twilight years, on approaching the 'use by date' roll back to a retail super fund to give away the onerous trustee responsibilities and increase death benefits via anti-detriment, which we now appreciate is best done with a retail super wrap.

We have just said that we have come full circle with our client, but does that mean that the circle ends? Is it possible that the circle simply renews itself and the SMSF wheel keeps spinning?

The 'win-win' solution

So when is a fund's 'use by date', how old will the client need to be when they switch from SMSF back to a retail fund? As important, how old will any of their children be at that point, and at what stage of the super cycle will those children be? There is no fixed date and it really depends on individual client's circumstances and objectives. However, some typical scenarios that may suggest that we are approaching the 'use by date' include:

- The existing client will be in their 60s to 70s (possibly gone past 'use by date' if 80s or 90s), particularly where health may be of concern;
- Their children will be in their middle age;
- This will correspond to when they (the children) should have accumulated some super assets and will be thinking about driving them forward for retirement – prime SMSF territory! and
- If any of the client's children fits the category for membership of an SMSF runs a business and requires a business real property or simply in a position to be able to consider LRBA growth strategies

Inevitably, many of the funds that we come across would have some involvement with an accountant – it is only a matter of degree, to a greater or lesser extent, depending on the client relationship with the accountant and the planner. For accountants, it may certainly be a hard concept for them to understand and ponder that any product which they may have helped set up, produce and run so very well for many years could actually have a 'use by date'. Indeed, aligning with their main principle – in the best interest of clients, we should be educating the accountants that like many quality products we see on a daily basis there are "use by dates' and SMSF is one of them.

As part of our financial planning "value proposition", we should be suggesting to SMSF accountants that together we review those SMSFs with older clients, and who are likely to be approaching or in fact gone past the 'use by date' with a potential to benefit from the anti-detriment enhanced death payment and to bring up the issue of intergenerational transfers by involving the children in the SMSF. This provides opportunities for both the accountants and planners to seek out and work with their next generation of clients and of course the exercise overall will still meet the prime objective of being 'in the best interest of clients'.

The higher the taxable amount, the higher the potential anti-detriment payment accompanying the member's death benefit. On occasions where the SMSF may not be sufficiently liquid due to the property element in the fund, then it may still be worthwhile considering rolling over whatever liquid funds there is available to the super wrap. In that instance, some additional anti-detriment on the liquid part rolled over has got to be better than no extra benefit at all on death.

The end result – it's a classic "win-win" solution all around:

- The client and their estate potentially benefit from anti-detriment payment which would otherwise not be available in the SMSF
- Problems of aging trustees, diminishing mental capacity and stress the client may or will have eventually with their SMSF are greatly diminished;
- Inter generational transfer – new generation of clients with potentially retention of the SMSF entering a new life cycle
- Rollover to a super wrap, potentially simplifying the client's estate planning matters;
- The accountant is not losing the SMSF – they may well have gained extra clients; and
- It is very difficult to deny the strategy (extra death benefit payment funded by the ATO) is not in the best interests of the client.

While the anti-detriment is certainly a valuable strategy that should always be considered, as financial planners, we should assess all the options. Anti-detriment tends to add greater value to death benefits paid to dependants as generally the additional benefit can be taken tax free. However, do not forget that anti-detriment is only available on the payment of a death benefit lump sum and therefore if the beneficiary wishes to put in place an income stream strategy, they will need to satisfy both the contributions rules and will be subject to the contribution caps. As always, there is no substitute for full and careful analysis in light of your individual client's needs.

We have been out with a number of financial planners on joint visits with them to their accountant referral sources and put forward this whole concept and strategy. The results have been astonishing with many of the accountants now taking a serious review of their 'use by date' SMSF clients. The message regarding the significance of receiving additional anti-detriment payment through a wrap account and the deficiency with SMSF when it comes to anti-detriment is gettingthrough to both accountants and planners alike. FS