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Super Insights

SMSFs & Reserves

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The ATO has recently issued its first guidance on reserves in SMSFs. It provides some contentious views (and reversals of previous views) from the Regulator. What are the implications for SMSFs with reserves or funds who aspire to use them?

INTRODUCTION

The ATO has recently launched a new stream of guidance and advice publications called an "SMSF Regulator's Bulletin" (SMSFRB). It would appear that the purpose of these bulletins is to allow the ATO to flag compliance issues it is concerned about or actively monitoring relatively quickly without the formality of other publications such as SMSF or Tax Rulings etc. It also explains how the Commissioner would apply particular legislation if asked via a formal process such as a private binding ruling. In that sense it is perhaps similar to a Taxpayer Alert but with some key differences:

- Its focus is both regulatory and tax issues rather than exclusively tax.

- A Taxpayer Alert is normally issued when the ATO already has significant evidence of a particular tax scheme and wishes to alert taxpayers about action that is already being taken. The SMSFRB series would appear to be more focused on pre-empting the widespread adoption of schemes by notifying SMSF trustees and their professional advisers where the ATO has concerns.

The first SMSFRB to be issued is SMSFRB 2018/1 which covers the use of reserves in SMSFs and adopts a fairly controversial stance on what the law does and does not permit. It also reverses the long held ATO position on some key issues – in particular the validity of allocating reserves to existing retirement phase pension accounts.

ATO'S CONCERNS ABOUT RESERVES

While reserves are not new (in SMSFs or indeed APRA regulated funds), the 1 July 2017 tax and superannuation reforms mean that reserves now offer new opportunities to circumvent the intention of tax law. In particular, SMSFRB 2018/1 identifies the potential for reserves to be used to intentionally:

- suppress an individual's Total Superannuation Balance below $1.6m (or $1.5m, $1.4m) which would allow the circumvention of the new limits on non-concessional contributions and the ability to "bring forward" future years' non-concessional contribution caps,

- similarly, suppress the Total Superannuation Balance to allow funds to segregate their pension assets for tax purposes despite new legislation designed to prevent this in certain circumstances,

- add funds to a retirement phase pension which has already been assessed against the Transfer Balance Cap (thereby allowing the cap to be circumvented to some degree), and

- suppress an individual's Total Superannuation Balance below $500,000 which would allow the circumvention of new rules limiting the "catch up" concessional contribution arrangements from 2019/20 to just those with relatively low balances.

In addition to the above concerns from a *tax* perspective, the ATO also has some concerns about reserves in a *SIS* context including:

- reserves where there is no clearly articulated *purpose* for the holding of the reserve,

- whether the use of a reserve adheres to the sole purpose test [SIS s. 62], and

- whether the SMSF trustee formulates, reviews regularly and gives effect to a strategy for the prudential management of a reserve consistent with the SMSF's investment strategy and its capacity to discharge liabilities [SIS s. 52B(2)(g)].

In fact the ATO opens the bulletin by expressing the opinion that reserves in SMSFs should be used "in limited circumstances and only for specific and legitimate purposes" [SMSFRB 2018/1 para 2]. This perhaps sets the tone for the rest of the document – the ATO clearly sees reserves as an exception rather than the norm for SMSFs.

WHAT WILL THE ATO DO ABOUT RESERVES?

The ATO's approach, as highlighted in SMSFRB 2018/1, can be broadly summarised as follows:

- They will not devote compliance resources to investigating the way in which reserves were created and used before 1 July 2017 providing they were permitted by superannuation law [SIS s. 115] and the governing rules of the fund, and the reserves do not appear to have been deliberately designed to circumvent the 1 July 2017 superannuation reforms. In practice, we expect there will still be some scrutiny of reserves during the 2016/17 financial year.

- Beyond 1 July 2017 it would appear that the ATO will specifically target funds with:
  - newly created reserves,
  - significant changes in reserve values (up or down), or
  - allocations of reserves to accounts in the retirement.

- The Commissioner will be specifically looking at these issues through the lens of the sole purpose test [SIS s. 62], the rules regarding the formulation, review and effect of reserving strategies [SIS s. 52B(2)(g)] and the general tax avoidance provisions of income tax law (commonly referred to as Part IVA). These are very significant threats – being found guilty of a breach of any of these potentially carries significant consequences.
  - This is not meant to imply that every new reserve or every increase in (or allocation from) an existing reserve will automatically fall foul of (say) the sole purpose test or Part IVA. There are some circumstances which will obviously result in significant changes in reserves (see below) and which will presumably be acceptable to the ATO. But it does mean that funds experiencing these events should expect scrutiny and be prepared to explain and defend their position.

NEW VIEWS OUTLINED IN SMSFRB

Reserves must have a clearly defined purpose

The two SIS provisions relevant to reserves are:

- SIS s.115 – which permits funds to maintain reserves "for a particular purpose, unless the governing rules of the entity prohibit the maintenance of a reserve for that purpose", and

- SIS s.52B(2)(g) – which provides that funds holding reserves must "formulate, review regularly and give effect to a strategy for their prudential management, consistent with the fund's investment strategy and its capacity to discharge its liabilities (whether actual or contingent) as and when they fall due".

The rules are therefore fairly broad unless specifically narrowed by the Fund's own governing rules.

While neither of the above explicitly require the trustee to <u>state</u> the purpose of the reserve, SMSFRB 2018/1 requires that the purpose of the reserve be clearly articulated.

Some existing reserving strategy documents will not necessarily have articulated the purpose for the reserve. They should be updated to do so.

Not possible to allocate reserves to a retirement phase pension account

Superannuation law is quite clear that once a pension commences, it is not possible to add rollovers or contributions to the pension account [SIS Reg 1.06(1)(a)(ii)]. However, the law obviously allows (in fact requires) investment earnings to be allocated to any member account on a fair and reasonable basis [SIS Reg 5.03(2)].

In cases where reserves are allocated to member accounts via an increased earning rate, therefore, it is common to apply the same enhanced earning rate to all *member* accounts – both pension and accumulation.

In fact, the ATO has previously expressed the opinion that this is specifically ***required*** where the trustee wishes to argue that a reserve allocation has been made fairly and reasonably. Trustees often wish to demonstrate that a particular reserve allocation occurred on a fair and reasonable basis because where a particular reserve allocation is both:

- less than 5% of the value of the member's interest at the time the allocation is made, **and**

- allocated in a "fair and reasonable manner" to all members (or all members of a particular class)

the allocation is exempt from the concessional contributions cap. Allocations that are either too large or not fair and reasonable (or both) count towards the cap.

The ATO has previously indicated that the Commissioner views "fair and reasonable" allocations to all members to apply to each and every member

account. This clearly indicates an expectation that the relevant share would be allocated to retirement phase pension accounts and transition to retirement income stream accounts as well as accumulation accounts.

SMSFRB 2018/1 expresses a precisely opposite view. While there has been no change in the relevant law, it would appear that the ATO ***now*** takes the view that to meet the requirements above, the allocation would need to be:

- less than 5% of the value of the member's overall interest at the time of the allocation (taking into account all interests – including retirement phase pensions),
- allocated fairly and reasonably to the individual members, but
- allocated exclusively to accounts that are not retirement phase pensions such as an accumulation account (where a member has no accumulation account, a new one would be created to which the reserve allocation would be added).

In other words, if the trustee chose to make a fair and reasonable reserve allocation of 3% of all members' balances at a particular date, a member with the following accounts:

- retirement phase pension: $500,000
- retirement phase pension: $200,000
- accumulation account: $300,000

would receive a total allocation of $30,000 (3% of $1m) but the ATO would expect the entire amount to be added to the accumulation account. We assume the same would apply regardless of whether the retirement phase pension was an account-based pension, market linked pension, allocated pension or a transition to retirement income stream (TRIS) that has already moved to retirement phase.

Unfortunately the SMSFRB does not provide specific examples such as the above but we hope the ATO will provide these later via their website or other material. Certainly their view on whether an amount can be allocated from a reserve to an existing account-based pension is an unequivocal "no".

The SMSFRB is silent on whether the allocation could be added to a TRIS that has not yet moved to retirement phase. This is another point we intend to formally explore with the ATO. Given that the Regulator's primary concerns appear to be the use of reserve allocations to circumvent the Transfer Balance Cap, it may well be acceptable to allocate reserves to a TRIS. Bear in mind, however, that:

- the ability to make reserve allocations to a TRIS does have tax benefits. For example, a reserve allocation added to a TRIS that is classified as 70% tax free component will effectively also become 70% tax free, and
- the legal provisions governing what can and cannot be added to pension after it commences are identical for all pensions.

There is a difference between "reserves" for superannuation law and tax purposes

SMSFRB 2018/1 expresses the view that "reserves" for the purposes of SIS largely includes only amounts that have been set aside for a specific purpose which relates to future contingencies and do not relate to any specific member (such as – in the past – to support an anti-detriment payment should a fund member die).

Amounts such as suspense accounts, contributions and rollovers not yet allocated to members etc are specifically not counted as reserves.

In contrast, the ATO takes the view that tax law explicitly extends this definition for certain purposes (eg treating some allocations to member accounts as being subject to the concessional contributions cap [ITAR 1997 Reg 291-25.01]). Importantly, the fact that an amount might be considered a reserve for tax purposes does not make it a reserve for SIS purposes.

One key example provided is the treatment of legacy defined benefit pensions such as complying lifetime pensions, life expectancy pensions and flexi pensions [provided under SIS Regs 1.06(2), 1.06(7) and 1.06(6) respectively].

The SMSFRB expresses the view that the amount set aside to provide these pensions is actually not a reserve as long as the defined benefit pension remains in place.

Once the pension ends, however, the position changes. If, for example, the primary pensioner and reversionary pensioner (if any) of a lifetime pension died leaving no further liability for the trustee to meet for this pension, the amount remaining *would* become a "reserve" for SIS purposes. Likewise, once the term of a life expectancy pension expires leaving no further liability for the trustee, any amount remaining would become be a reserve for SIS purposes.

For tax purposes, however, the amount set aside to fund the defined benefit pension is considered a reserve both while the pension is on foot and after it ends.

Some reserves are not appropriate for SMSFs

The SMSFRB expresses the view that some reserves are appropriate for large funds but not SMSFs. Included here would be:

- Administration reserves (designed to spread administration and operational costs over multiple generations of members),
- Investment reserves (designed to smooth the allocation of investment returns over time),
- Operational risk reserves (generally actually only used in large funds in any case to meet APRA requirements around risk mitigation),
- Self insurance reserves, and
- Reserves that meet insurance premiums for policies held in respect of a member and would receive insurance proceeds in the event of a claim.

Of course some SMSFs will already hold reserves for the purposes outlined above. The implications of the SMSFRB is that trustees of such SMSFs should take steps to wind these reserves down over time and should certainly not seek to extend their use or create new reserves in SMSFs that currently do not have them in place.

In fact, the SMSFRB indicates that SMSF trustees holding these reserves "may be required to demonstrate that the use of the reserve or account is not part of a strategy employed for the primary purpose of circumventing restrictions in the superannuation and income tax laws and obtaining a tax advantage to which Part IVA of the ITAA 1936 could apply" [SMSFRB 2018/1 paras 37, 40 & 43].

The very strong language used in the SMSFRB and the fact that trustees should expect to defend their position if they hold such a reserve certainly conveys an impression of "guilty until proven innocent"!

WHERE TO FROM HERE?

Of course the views expressed in the SMSFRB are not law but they are clearly the considered position of the Commissioner who applies both the tax and superannuation laws for SMSFs. Generally, it makes sense to follow the Commissioner's guidance unless there is a specific case where the trustee believes they have a strong contrary position and are willing to participate in legal action with the ATO.

As a result we expect that many SMSFs will:

- no longer seek to create new reserves unless they have no choice (for example, a reserve will automatically be created if the primary and reversionary pensioners receiving a lifetime pension die or if a defined benefit pension is commuted and the commutation value is less than the relevant account balance at the time),
- actively look to wind down existing reserves by progressively allocating amounts to all members' accounts (taking into account the new complexity of the ATO's change in view about allocations to retirement phase pensions), and
- ensure that their documentation articulates the purpose of any existing reserves and/or its origin so that they are well positioned to defend any scrutiny.

Unfortunately the SMSFRB offers no assistance in how trustees might expedite the wind down of their reserves given the strict controls now in place that effectively impose substantial tax consequences for most reserve allocations beyond the "less than 5% and fair and reasonable" allocation process above.

It is worth bearing in mind, however, that:

- Any "less than 5%" allocation can still reflect the full value of the member's interests in the fund even if it must all be allocated to an accumulation account (SMSFRB 2018/1 para 52 refers to "a member's total interest in the superannuation fund").
- The consequences of exceeding the above limit in any financial year is that the entire allocation is treated as a concessional contribution. Bear in mind that for some members this may not be overly concerning (depending on the actual size of the allocation). For example:
  - Every individual has a concessional contributions cap of $25,000 pa (even those who are too old to make contributions). An 80 year old therefore has up to $25,000 pa available with no negative consequences.
  - Exceeding the concessional contributions cap simply means that the excess is treated as assessable income to the individual and taxed accordingly. If the individual has no other

assessable income, quite high amounts can be received before this is necessarily problematic.
  - The ATO also calculates earnings on the excess at a statutory rate and these earnings are also treated as assessable income to the individual and taxed accordingly. Providing the SMSF's annual return is lodged promptly, however, and the ATO issues the excess determination soon afterwards, the amount of the associated earnings may not be large.
  - When the additional personal income tax is determined on the excess and associated earnings, it is reduced by a 15% tax offset (ie 15% x the gross amount of the excess). Normally this is completely appropriate (an excess concessional contribution would normally have been subject to 15% contributions tax in the fund on receipt). In the case of a reserve allocation, however, no such contributions tax is applied to the allocation - the 15% tax offset is effectively just a bonus that reduces the personal tax consequences of the excess.
  - If the excess remains in the fund, it will of course also be assessed against the non-concessional contributions cap. While older individuals have such caps at the normal levels (eg up to $100,000 pa), remember that from 1 July 2017 the cap is $nil for those with a Total Superannuation Balance of more than $1.6m at the previous 30 June. It may therefore be advisable to elect to remove the excess from superannuation when the ATO issues the excess determination.

- In our view, there is no legal requirement to add earnings to a reserve each year. While there are provisions requiring investment returns to be allocated "in a way that is fair and reasonable as between:

  (a) all the members of the fund, and
  (b) the various kinds of benefits of each member of the fund"

  these provisions explicitly link the fairness requirement to members and their benefits, not amounts kept in reserves which are owned by the trustees, not the members [SIS Reg 5.03(2)].

Historically practice has varied – some funds have chosen to allocate investment returns to all member accounts <u>and</u> reserves while others have stopped allocating earnings to reserves once they are large enough to meet whatever purpose they have.

We will be seeking clarification from the ATO that the Commissioner also considers this approach reasonable.

We are aware that some SMSF trustees have made reserve allocations to retirement phase pension accounts on or after 1 July 2017 but before the release of SMSFRB 2018/1. Such action is obviously now contrary to the ATO's new position and we expect trustees will need to defend their action. In our view, trustees have a defensible position where:

- the establishment of the reserve was permitted by SIS and the fund's governing rules,

- the facts do not indicate that the reserve was used by the trustee as a means of circumventing the Government's 1 July 2017 reforms (eg the establishment of the reserve was a consequence of the cessation of a defined benefit pension arrangement), and

- reserve allocations had been made to pension accounts prior to 30 June 2017.

CONCLUSION

Those with extremely large reserves will find that they remain in an extremely difficult position. A practice adopted in the past entirely legally is now represented by the Commissioner as something that needs to be explained and defended and yet the law provides no simple way to take the action the Commissioner ultimately seeks (full allocation of reserves to member accounts). A simple legislative change to deal with legacy reserves would be to provide an amnesty that allows all funds to allocate them in full without triggering excess contributions tax. We will continue our efforts to encourage Treasury and the ATO to support such a change.

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