ACIS

AUSTRALIAN COMPANY INCORPORATION SERVICES

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1. Overview of Budget Night SMSF Changes

On Tuesday night, we saw an example of policy devised in secret over what would seem to be a considerable period of time, drafted in secret without any consultation with members of the industry affected, sprung as a surprise, gazetted the next day and industry given an astonishingly short five (5) day period for comment before the Government considers them a fait accompli.

Most would find both personally and professionally objectionable Senator Coonan's blanket characterization of life pension, reserving and non-vesting of certain benefits by SMSF's as "tax avoidance arrangements". We certainly do. We do not advise our clients in tax avoidance strategies – were we to do so, we have no doubt the Australian Taxation Office would be on our doorstep, waving a copy of Part IVA in our face. Especially galling is the implicit assumption that these same arrangements, when undertaken by large funds, are not "tax avoidance", but a legitimate part of the system.

After getting off to a bad start, the Minister uses less inflammatory language in the balance of her press release. She indicates that these strategies, when used by small, as opposed to large, funds can result in concessionality beyond Parliament's intention and that they offer estate planning opportunities and protection from creditors in bankruptcy, even access by wealthy individuals to social security benefits.

The Minister therefore provides us with a framework to address each of the proposed changes in turn and summarize: what the changes are; how some people might have been using them for "tax avoidance"; how they have been legitimately used; and what the consequences (intended or otherwise) of the Government's actions will be.

2. Contribution Reserving Strategies by SMSF's

In the last five or six years, some within the industry have actively and aggressively promoted the use of reserving strategies in SMSF's. There have been a number of ideas as to how these could be used. The first was the use of contributions reserves to defer and (hopefully) to reduce the impact of the superannuation contributions surcharge tax. The idea rests on the concept that, while a deduction contribution may be made by an employer in respect of a member, the liability to surcharge does not occur until that contribution is allocated to the member's account. While in the reserves, certain administrative and other expenses could also be deducted. The Commissioner of Taxation appeared to give credence to the use of contributions reserves, via the ruling SCR 1999/1. This ruling sets out the circumstances in which surcharge will apply to contributions and when it will arise. It also seemed to tacitly acknowledge that, if you were prepared to cop the surcharge, contributions which were make using one member's deductible contribution limit could actually be allocated against another member's account (if, for example, one member was in RBL trouble and another was not, in which case the 30% contributions tax might not be such a bad thing).

Reserves are legitimately used by large superannuation funds when an employer makes a contribution on a given day, in one amount for numerous employees and follows up with the paperwork later. In such cases, all amounts go into contributions reserves and are later allocated to individual members by the fund's administrator, when the paperwork is processed.

The Government's changes require that all amounts contributed to an accumulation fund be allocated within 28 days after contribution, or such longer period as is "reasonable in the circumstances." Interestingly, this regulation is not restricted to SMSF's. By allowing the 28 day window, there would still seem to be an opportunity for surcharge deferral from one year to the next, if the contribution concerned is made in June of a given year. However, some of the more aggressive uses of contributions reserves will not, now, be allowable.

We have never promoted the use of reserves (although we discuss the issue with anyone who asks and our deeds allow it), as this is one area which we believe lies close to the mark between tax "minimization" and "avoidance".

3. Benefit Forfeiture Rules

This is an interesting one. The Government says they are concerned that people may be forfeiting benefits in small funds to deal with excess benefits problems and to avoid creditors in bankruptcy. As regards excess benefits, some super fund trust deeds have a clause to automatically forfeit benefits over the pension RBL, while most allow for some form of voluntary forfeiture of benefits arising from voluntary employer contributions.

The solution has been to introduce a regulation, Regulation 5.04(2), which states "If the fund is an accumulation fund, the member's minimum benefits are all of the member's benefits in the fund." To understand how this regulation works, you need to understand the way in which "vesting" of benefits works in the superannuation environment, as well as the definition of "minimum benefits".

Some older players will recall the "vesting schedule" which used to be a standard back page to super fund trust deeds. It contained years and percentages (eg. 1 yr – 5%; 2yrs – 10%; 3yrs – 15%; etc.). The concept was that an employer made a contribution to a fund on behalf of an employee, but the balance appearing in the member's account at the end of the year was only a "notional" balance for accounting purposes. The employee was only absolutely entitled to that amount which matched their period of service with the employer – eg. if you'd been working for one year, 5% of the benefit would "vest" absolutely in your name; two years and 10% would vest, etc. Used judiciously, these arrangements could be an effective loyalty device for employers. Used with abandon…well, there were quite a few super funds where, at the end of the day, only the directors remained and inherited quite a large amount of "forfeited" benefits.

From the early 1990's there was a concept of "minimum benefits" inserted into the law, which encompassed member contributions, super guarantee contributions and the earnings accruing from them. These minimum benefits were absolutely vested in the member, from day one. Therefore, only benefits derived from employer voluntary contributions could be subject to progressive vesting arrangements. It should be noted that, once a benefit is "vested" absolutely in a fund member, no-one (not even the member, voluntarily) can di-"vest" themselves of it.

Therefore, by stating that all of a member's benefits in a fund are to be minimum benefits, the Government is effectively attempting to stop all forfeiture of benefits in all circumstances, because all benefits will be fully vested, from day one. (It should be noted that there are transitional provisions for all vesting arrangements in place prior to 12 May 2004 to continue.)

We see three areas where this might have an effect. The first is in forfeiture due to excess RBL problems, which would now seem to be ruled out. The second relates to forfeiture in the event of bankruptcy. This does not mean that the trustee in bankruptcy has *carte blanche* to access the bankrupt's super. If the member has not yet reached retirement age as at the time of the bankruptcy (i.e. their benefits are still preserved), the only way for a trustee in bankruptcy to access the benefits is by utilizing the provisions of the *Bankruptcy Act 1966* to do so. If the member has reached retirement age, there seems to be no question that the trustee in bankruptcy can call on the member's benefits to pay the debts.

There is, however, a third – perhaps unintended – area which might be affected by this change, an example of which follows. ACIS' deed contains a special provision which deals with the proceeds of life insurance policies. Take the example of a member who has, say $300,000 in assets in the fund and the trustees of the fund take out life insurance for $500,000 on that member. Our insurance provision (called "benefit payment" insurance) states that the insurance is for the purpose of insuring the fund's obligation to pay out the $300,000 only. The trustees may choose to pay out more than the $300,000, should they wish, but they are not obliged to do so. Any additional amounts can be placed in a reserve for later allocation to members.

This is not a tax avoidance mechanism, as the proceeds of life policies paid from superannuation are deductible up to the pension RBL. Instead, it primarily exists because: (a) there is a six month period during which death benefits must be paid, in order to obtain the exemption from taxation on benefits; and (b) super funds often contain illiquid assets, such as direct real property, which may not be capable of realizing an appropriate value if a quick sale is needed. Indeed, if the two members of the fund are business partners and their business' premises is in the fund, having a member die suddenly can cause all sorts of problems if the property needs to be sold or transferred to the dependents of the deceased member (who may then want to force a sale). The death benefit insurance option solves this very practical problem.

We are not yet certain whether Regulation 5.04(2), as gazetted, will affect this strategy. For a start, the section applies to "all of a member's benefits in the fund". It is not yet certain whether the "optional" component of the proceeds from a policy of insurance paid to a trustee under the "benefit payment insurance" conditions our deed would qualify as being the "member's benefits", or whether the compulsory amount is all that is required to be paid. This needs more detailed consideration and research than the three days we have had to date. We will let you know.

This is just an example of the potential unintended consequences of this type of amendment. We are sure that more will surface, as time passes.

4. Lifetime and Life Expectancy Pensions

The big fund lobby groups (oops, sorry – the "Government") have been concerned that there might be unintended estate planning opportunities for SMSF's paying lifetime and life expectancy pensions (now called "defined pensions"), which do not exist with larger funds. Therefore, from Budget night,

SMSF's will be prevented from paying such pensions, unless the SMSF has purchased the pension from a life insurance company.

Lifetime pensions were never a popular option for retirees. The returns were too low and the loss of right to capital was considered by many to be too high a price to pay for the amount of tax which was saved. A few years ago, the Government tried to breathe some life into this area by introducing "life expectancy" pensions, which only needed to be guaranteed for the lesser of the member's remaining life expectancy, or 15 years. These were marginally more popular – but not by much.

For twenty years actuaries had not been able to satisfy themselves that a SMSF could give the kind of guarantees of an income stream for life which were provided by a large fund or life office (with a large pool of pensioners, some of whom died early, some late). Without an actuary's certificate, a fund cannot operate a defined pension. However, in about 2001, there was some movement on this area. The Institute of Actuaries of Australia released a practice note outlining conditions upon which it could be done. Suddenly, interest in defined pensions took off!

One of the main stumbling blocks with these instruments was that, they were great, if you lived to be 105 years old. However, if you died shortly after signing away your capital, that was tough luck – your capital went into the pool to pay the bill for someone you never met. In a SMSF, however, you knew who the other members were going to be. So, even if you died early and the benefits couldn't be released out of super (only redistributed to the other fund members), at least it wasn't lost to a pool of unknown people.

So, what is inherently wrong with this? Well, the Government says it opens up "unintended estate planning" opportunities. We strongly disagree. What the Government is effectively saying is that, if you die with money still in your pension account, it would be obnoxious to the Parliamentary intention if the balance went to top up the super of someone you know, however it would be absolutely fine if it went to someone you had never met! Why, Minister, is my spouse's or childrens' right to participate in a pension pool unacceptable, whereas some stranger has a perfect right to it?

They do rightly say that, in certain limited circumstances (eg. where there are no remaining members in the fund upon the pensioner's death) the money can be paid to the deceased member's estate (although the Tax Office gets a hefty slice), however this could have been fixed by simply preventing these distributions, rather than killing off the ability of SMSF's to pay these types of pensions.

If the big funds (oh, we did it again – we mean the "Government") thinks that stopping SMSF's from paying these types of pensions will lead to a revival in the fortunes of their retail pension and annuity business, they had better think again. They were unpopular to start with, for the reasons outlined above, and the only reason most people took them up was because of the ability to minimise the impact of the assets test on social security pensions. With 50% of the capital value of these types of pensions being counted after 20 September 2004, the decline in retail defined pensions will, no doubt, continue.

5. Transitional Arrangements for Existing Funds - Defined Pensions

Interestingly, the provisions preventing SMSF's from paying defined pensions does not seem to affect existing funds which are either presently paying a

defined pension, or whose deed allowed for these types of pensions to be paid before 12 May 2004.

In the Explanatory Statement accompanying the new regulations, the Government says:-

> "The new division will not prevent a defined benefit pension from being paid by an existing superannuation fund where the governing rules of that fund set out the terms and conditions of the pension prior to the commencement of these regulations."

However, this is not what the actual regulation (Reg. 9.04F) says. In fact, this regulation says that an existing fund *can* pay a defined benefit pension, *unless* the fund is:-

> "a regulated superannuation fund established before the commencement of this Division, the governing rules of which are amended after the commencement of this Division to provide for the payment of a defined benefit pension." [Reg. 9.04F(1)(b)]

Now, there is a big difference between having governing rules which simply provide for the payment of a type of pension and having governing rules which set out in detail the terms and conditions of such a pension. In this regards, the Explanatory Statement does not accord with the Regulations. If the Regulations are not amended, to more closely mirror the Explanatory Statement, we can expect that virtually every superannuation fund in existence prior to 12 May 2004 will be able to pay defined benefit pensions in future.

Take the ACIS trust deed, for example. In our deed, we state that the primary form of benefit is a "pension". "Pension" is defined as any type of benefit which meets that definition in the *SIS Regulations*. Therefore, a fund operating under a ACIS deed can pay an allocated pension, a lifetime pension, a life expectancy pension and, shortly, a "market-linked" pension.

As the Regulations currently stand, it would seem that such a fund in existence before 12 May 2004 could pay defined benefit pensions at some time in the future. However, if the Regulations are modified to accord with the Explanatory Statement, requiring that the governing rules must have set out the terms and conditions of the pension prior to 12 May 2004, there may be some uncertainty. Without doubt, the ACIS deed contains many terms and conditions under which pension benefits are to be paid, however it also refers to further conditions contained in the *SIS Regulations* which must be satisfied.

Would this be enough? At this stage, the question is moot, because the Regulations are the law, not the Explanatory Statement.

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