RICHARDS FINANCIAL

COVID-19: NEGATIVE RETURNS – LOOKING FOR THE POSITIVE?

Despite well formulated investment strategies and appropriate investment advice, no trustee could have foreseen the impacts of COVID-19 on financial markets globally. Whilst history suggests that a strong recovery is likely within a relatively short period after large market corrections, it is still too early to know the impact of COVID-19 on members' retirement plans.

If your SMSF has experienced some negative returns, there may be an opportunity to ensure member benefits are restored in the most tax effective manner. Particularly if members are approaching retirement and do not have the luxury to wait for markets to recover.

A member's superannuation interests comprise two components — the tax-free component and the taxable component. Under the proportioning rule, when a superannuation benefit is paid as either a lump sum or as a pension, the trustee must split the benefit between these two components. Members cannot select their tax components.

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If a member has an accumulation interest, their tax-free component is based on a prescribed formula. All residual benefits, including all investment earnings, then make up their taxable component. By the same token, any negative returns reduce their taxable component until it is exhausted before notionally reducing the tax-free component.

Where the value of a member's account falls so that it is less than their prescribed tax-free component, any notional or temporary reduction in the dollar value of a member's tax-free component can be recouped.

In essence, whilst a member's balance remains less than their prescribed tax-free component, they are able to restore their tax-free component. This presents an opportunity to reclassify what would ordinarily be treated as taxable component as tax-free, until a member's prescribed tax-free component is restored. For example:

•Investment earnings can be treated as a tax-free component.

•The net amount of concessional contributions made based on theannual cap and any unused carried forward cap can be treated as a tax-free component.

•Any taxable benefits rolled over by a member from another superprovider can be reclassified as a tax-free component.

Once a member's prescribed tax-free component has been restored, as trustee, you must revert to treating the above-mentioned amounts, as part of a member's taxable component.

Once a member has restored their tax-free component, they may be eligible to nominate to start a pension. Where they opt to start a pension, as trustee, you must apply the proportioning rules to work out the tax-free and taxable components of their pension. All benefits subsequently taken from the pension will be taxed based on the same proportion, which does not change.

Get the timing right and a member can essentially 'lock in' the components of their pension with a high tax-free component, ensuring that all future earnings are classified as tax-free component. This has significant estate planning benefits where they potentially have adult children beneficiaries.

If a member is only eligible to start a transition to retirement income stream (TRIS) the proportioning rules operate in the same way. Although the TRIS would not be in retirement phase and enjoy a tax exemption on income generated by the pension assets, all earnings and capital growth will increase the tax-free component of the pension proportionately. The alternative of retaining benefits in accumulation would see all earnings only increase the member's taxable component. This opportunity is also not restricted by the

$1.6m transfer balance cap limit and the member can enjoy a higher proportion of tax-free pension payments, even where they are under 60.

As a trustee you need to be aware of the different tax components that make up members' benefits to ensure that member records are accurate and that the correct amount of tax is withheld.

It is also important for member's to be informed to ensure they do not make the wrong decision. For example, should a member decide to roll-over their entire benefit before recouping their prescribed tax-free component, the proportioning rule will be triggered, and their reduced tax-free component as calculated on the day of the rollover will be fixed. Their decision permanently reducing their prescribed tax-free component.

How can we help?

If you need assistance with planning for an unexpected event or reviewing your current strategies, please feel free to give me a call to arrange a time to meet so that we can discuss your particular circumstances in more detail.