

Anti-detriment deductions

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Anti-detriment deductions are one of the most powerful super strategy available. However, despite having been in existence for over 20 years, they are extremely poorly understood ... even by many super professionals! This article seeks to provide a basic overview of these useful deductions.

Anti-detriment deductions were introduced from 1988 when certain super contributions were first required to be subject to income tax in super funds. The deductions seek to ensure that children and spouses of deceased super fund members don't suffer any detriment as a result of contributions tax. They are best explained with a simple example.

Consider Dad, who makes a concessional contribution to a brand new super fund of \$100,000. Naturally, the super fund must pay \$15,000 tax on the contribution, leaving \$85,000. If Dad then died, there would only be \$85,000 left in his member account to pay to his spouse or children. Naturally, if the contributions had not been subject to income tax, Dad's member account would have \$100,000 in it instead of \$85,000. In other words, there is a detriment of \$15,000 (ie, \$100,000 – \$85,000). Tax law says that if the super fund pays out to the spouse or children not just the \$85,000 but also the detriment amount (ie, \$15,000), the super fund gets a big deduction. The deduction is calculated as the detriment amount divided by 15% (ie, a deduction of $\$15,000 \div 15\% = \$100,000$). This way:

- the spouse or children have received the same amount that they would have received if the contribution had not been taxed; and
- the super fund gives a big deduction to compensate it for paying the 'top up' amount to the spouse or children.

This is a simple example, but in real life several issues arise.

The first main issue is: how to calculate the detriment amount? In the simple example, it was clearly \$15,000, but often the outcome is not easily ascertainable. There are three common methods to calculate the detriment amount. Other methods also exist. The first method involves auditing the fund's records and calculating the actual amount of tax paid plus a few extra amounts (eg, the earnings that would have been earned on the tax paid amounts). If super funds can use this method, legally they should use this method. The second and third methods both involve formulas from the legislature and the ATO. The formulas are structured such that if someone has engaged in a withdrawal and re-contribution strategy (ie, the tax free component of their interest has been maximised) the tax detriment amount calculated ends up being very small and hence the resulting anti-detriment deduction ends up being very small.

This has led to the misconception that super fund members face a trade off between maximising the tax free component *or* using an anti-detriment deduction strategy. This is only true when using the second or third method of calculating the detriment amounts! If a super fund uses the first method, they can have their cake and eat it too! Up until now, only a handful of people in Australia have known this.

The second main issue is: where to get the extra money from to pay the detriment amount? In the simple example, the super fund only had \$85,000, so where can it find the extra \$15,000? One answer is from reserves. A super fund is allowed to maintain a pool of money that is not allocated to any specific member. This is known as a reserve. Reserves are quite common in large super funds, but rarely used in self managed super funds. An SMSF that does maintain a reserve and uses money from there to pay the detriment amount is under a strict legal obligation to have a reserving strategy in place. The reserving strategy requirement is different from the investment strategy requirement. Any good SMSF law firm should be able to provide guidance and template reserving strategies. DBA Butler offers a Reserving Kit for \$440.

What about self managed super funds that don't have reserves? All is not lost. If the deceased member had life insurance in the fund, the insurance pay out does not necessarily have to be allocated to the member's account. Instead, provided the super fund's specific governing rules (usually annexed to the trust deed) allow for it, the super fund can have a discretion as to how much of the insurance pay out to allocate to the deceased's account and how much to allocate to say a newly formed reserve. An amount can then be paid from the reserve to the deceased's spouse or children as the detriment amount. If this technique is being used it is absolutely vital that the fund's trust deed has been written by lawyers with SMSF and tax expertise as this strategy hinges off the provisions of the trust deed.

What if there are no reserves and there is no insurance? There are still strategies, however, to discuss them would go beyond the scope of this article. If you have no reserves and no insurance, you are well advised to contact a lawyer with SMSF and tax expertise.

The final issue is the high level of ATO scrutiny that anti-detriment deductions attract. An anti-detriment strategy typically results in a deduction for the super fund of anywhere from \$100,000 to \$1 million or more! When the income tax return is lodged, an ATO 'please explain' letter invariably follows. Accordingly, it is strongly advisable to seek legal input before engaging in such a strategy so as to ensure that every dollar of deduction claimed is 100% legitimate, since there is a very good chance the ATO will be looking closely at the deduction.

The best way to conclude is with a case study to demonstrate the potential use of these strategies. Consider John whose date of birth is 1 August 1933. His SMSF has \$2 million of real estate in it. John's benefit in the fund is comprised entirely of the taxable component. He has two financially dependent children, both 30 years of age. John has an eligible service period commenced on 1 January 1990. John dies on 1 August 2008. Because death is a compulsorily cashing event and his children are ineligible to receive his death benefits by way of pension, the real estate must be transferred over of the fund. This triggers CGT event A1 within then fund.

Without the anti-detriment amount, the fund pays \$125,000 of income tax. However, if the fund has been structured with an appropriate amount of reserves and it has appropriate paperwork to allow for anti-detriment deductions, it can claim a deduction of approximately \$1.86 million which wipes out of the CGT from the transfer out of the real estate and can leave the super fund with substantial carried forward losses. These losses can be used to offset any assessable earnings (including contributions) in the fund. To obtain these calculations, email the author at bfigot@dbabutler.com.au

The real detriment is not tax on contributions. The real detriment is suffered by those who don't know how to harness this powerful strategy.

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