Preservation components vs tax components when paying benefits

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When it comes to superannuation interests the trustee must keep track of two key components which can cause some confusion, especially when it comes to paying benefits.

A contribution or transfer into a self-managed super fund (SMSF) will often have a specific preservation and tax status. It is important to understand how these components then interact within the fund when it comes to paying benefits from the SMSF.

The preservation and tax components of a superannuation interest are separate concepts with respect to payment of benefits.

Preserved components of a superannuation interest

All contributions, and all fund earnings since 30 June 1999, are known preserved benefits in superannuation. Some SMSF members may also have restricted non-preserved (RNP) benefits which generally stem from employment-related contributions (other than employer contributions) made before 1 July 1999. These benefits cannot be accessed until a member meets an appropriate condition of release.

A member can also have unrestricted non-preserved (UNP) benefits which for example includes benefits for which a member has previously satisfied a condition of release, and certain employer termination payments received by the fund before 1 July 2004. These benefits don't require a condition of release to be met in order for the benefits to be paid.

When cashing benefits from a superannuation interest, Regulation 6.22A of Superannuation Industry (Supervision) Regulations 1994 identifies that trustees must give priority to benefits in the following order:

1 – UNP
2 – RNP
3 – Preserved

For example, if a member's transition to retirement pension interest is worth $100,000 made up of $10,000 UNP and $90,000 preserved amounts then if the trustee pays a benefit of $20,000 to the member as a pension payment, this will use up all of the $10,000 UNP amounts and $10,000 of the preserved amounts. The remaining $80,000 pension interest will be entirely made up of preserved monies.

When commencing a pension interest trustees can elect what preserved components to utilise in commencing that pension where only part of a member's accumulation interest is used to commence the pension.

For example, consider a member aged 58 who has an accumulation interest with $200,000 comprised of $80,000 UNP and $120,000 preserved amounts. She wants to start winding down to retirement and commence a transition to retirement (TTR) pension with her balance. The trustee could commence one TTR pension with the member's entire $200,000 balance and payments will first draw down on the UNP component until it is all used up, and then payments will draw on the preserved component.

Alternatively the trustee could commence two pensions, one pension with the $120,000 preserved amount and the other with the $80,000 UNP amount. This would ensure that as pension payments are made on the TTR pensions, the member is using up some of their preserved benefits. In particular any payments above the minimum pension requirements up to the 10% TTR limit could be made from the preserved pension, retaining the more flexible UNP benefits for future use.

Tax components of a superannuation interest

Superannuation benefits paid to members under age 60 may be subject to tax. In order to calculate and withhold the correct amount of tax, the trustee will first need to calculate the tax components for each benefit paid. Generally, the proportioning rule is used to work out the tax components by determining the proportion of the tax-free and taxable components of the interest, and applying these proportions to the benefit.

The amount of each component is determined at different times depending on the type of benefit. In pension phase the tax free and taxable component is determined at the commencement of the pension and all benefits taken from the income stream are taxed based on that same unchanging proportion.

For benefits paid from an accumulation interest the tax components will need to be determined just before you pay the benefit as the tax components may be constantly changing as the interest receives contributions and earns income.

For example, consider a pension commenced on 1 July 2015 with $200,000 and the tax components were determined to be 40% taxable and 60% tax free. Then, if the trustees make a pension payment to member in 2016 from that pension interest of $10,000 and the member is under age 60, then tax may be payable on $4,000 of the benefit.

If the benefit was paid from an accumulation interest the tax components would need to be determined just prior to paying the benefit in order to determine the taxable proportion of the benefit payment.

Paying benefits from a superannuation interest

In isolation these two concepts may be understandable. However things can get complicated where certain preserved components are received with specific tax components.

What does this mean for paying benefits when these monies are pooled with other preserved and tax components in the SMSF?

It is important to remember that tax components and preservation components remain separate concepts with respect to payment of benefits. Once monies are received by the SMSF the preserved components and tax components of the member's entire accumulation interest will update appropriately. Any new preservation amounts will simply add to the appropriate type, increasing the UNP, RNP or preserved component of the interest. Similarly the tax components of the entire accumulation interest will update and the interest will have one tax free and taxable component. This is best explained with an example.

Case study: Paying benefits from a pension with UNP components

- A member commenced a Transition to Retirement Pension in the 2016 financial year (partway throughout the year).
- Immediately prior to the pension commencement the member had a mixed balance of both preserved & UNP amounts. The member's total balance is $1 million.
- The UNP component of $230,000 was 100% taxable when it was received by the fund.
- At the pension commencement, the 'locked-in' tax-free percentage was determined as 47%.

If the member is paid a pension payment this will come out of the UNP amount first, based on the order of cashing benefits. Is this payment taken to be 47% tax free or would it be entirely taxable since it is from the UNP amount?

The payment will be 47% tax free because once the UNP was received by the fund the preserved and tax components become separate considerations, the 100% taxable status of the UNP amount received no longer solely relates to the UNP amount, instead the amount would have contributed to working out the overall tax free and taxable components of the interest. Once a pension was commenced with the member's interest the tax free proportion at that date is locked in and all benefit payments from the pension interest will have that same tax-free proportion.

Phone: 1800 203 123
act@accurium.com.au
www.accurium.com.au

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