Wending through the superannuation labyrinth

By Garry Pammer, CA, BEc, LLB

"if a member breaches both the concessional and non-concessional contribution caps, the effective tax rate on the excess could be as high as 93%!"

The festive season is a lot of things to a lot of people. Family plays a big part for many. I am no different in this regard. Some time with my daughter on the beach highlighted one of my cognitive weaknesses.

The labyrinth on the beach

My daughter and I wandered down to my boyhood beach as a bit of a break from the extended family get together at my parent's house. She started drawing a circuit labyrinth in the sand. I expressed my surprise and she explained how easy it was. She stood up and started on a larger scale, beginning with a cross she started drawing a large connecting arc and then back creating a path boundary through whose lines we could both walk. It became bigger and bigger, all the time she explained each arc commencing from the next point to the left and sweeping clockwise toward the next point to the right of the last. Back and forth she went and sure enough we walked through the multi circuit labyrinth from its entrance to its end.

I didn't get it. In fact I still struggled with it conceptually when drawing it with my finger in the sand on a smaller scale. Yet she managed to draw one of immense proportions on that beach with no bird's eye view or aerial perspective.

My sense of self worth was somewhat restored later that day at home over dinner. You always get the dental questions at dinner parties when

everyone realises there's a dentist present right? I mean I've certainly sat there and watched a friend examine some dental work using two inverted silver parfait spoons to hold a mouth open (it was pretty

late in the evening I hasten to add). Well, tax accounting questions often prevail when I am around and the extended family theme this year seemed to be superannuation: getting the most in, the limitations, the timing, the caps, the tests, the concessions, etc. I just prattled on about the traps and tips with a similar confidence to that exhibited by my daughter explaining the construction of the labyrinth earlier that day down on the sand.

It all made perfect sense to me. Nobody else really got it. In the end I just told each family member what they should and should not be doing.

The boundaries of the super labyrinth

Unlike a true labyrinth, you can actually step outside the superannuation cap boundaries set out by parliament in the Simpler Super changes made to superannuation in 2007. Members are not in fact prohibited from making contributions in excess of the concessional and non-concessional contribution caps. Members almost always still obtain a full tax deduction in their own personal tax return for their superannuation contributions. However, it is only in limited circumstances that it remains a tax effective strategy as outlined in my article *When is Excess not Excessive?* in the March/April 2010 edition.

Therefore the actual boundaries are:

- that superfund trustees are not allowed to accept contributions in excess of the caps in certain circumstances; but
- the bigger deterrent is played by the excess contributions tax.

Table 1. Contributions a fund trustee can accept

Member age	Acceptable fund contributions
Under 65 years	Contributions made on behalf of a member
65 to 69 years	Contributions made that are either: a) Mandated* employer contributions; or b) Employer contributions or member contributions if the work test** is met in the year the contributions are made.
70 to 74 years	Contributions made that are either: a) Mandated* employer contributions; or b) Employer contributions or member contributions if the work test** is met and the contributions are received within 28 days of the end of the month in which the member turns 75
75 years or more	Mandated* employer contributions only

* Superannuation Guarantee based contribution.
** During the year the contributions are made the member must have worked at least 40 hours during a period of 30 consecutive days.

Concessional contributions

Concessional contributions are so named because they are essentially made from pre-tax earnings and are taxed at a concessional maximum tax rate of 15% on entry to the superannuation fund. The caps limit the amount of concessional contributions a person can make that will continue to attract this concessional taxation treatment.

Concessional contributions include:

- Super Guarantee contributions;
- Salary sacrifice contributions;
- Voluntary employer contributions;
- Personal contributions for which a tax deduction has been allowed; and
- Any contribution made by an entity such as a company or a trust (i.e. an entity cannot make non-concessional contributions).

Non-concessional contributions

Non-concessional contributions are so named as they are generally after tax contributions that do not attract any tax when deposited into the superannuation fund.

Non-concessional contributions include:

- Personal after tax contributions;
- Personal contributions on which a tax deduction has been disallowed by the Tax Office; and
- That portion of concessional contributions which are in excess of the concessional contributions cap.

Table 1 sets out a summary of the contributions a fund trustee can accept. Table 2 sets out a summary of the current contribution caps and the excess contributions tax that applies.

You can see in columns 1 and 2 of Table 2, where concessional

Table 2. Current contribution caps and the excess contributions tax

	Concessional cap	Transitional concessional cap	Non-concessional cap
2011 financial year	$25,000	$50,000	$150,000
Tax on amounts exceeding the cap	31.5% plus 15% already paid by the superfund	31.5% plus 15% already paid by the superfund	46.5% plus the income tax already paid by the member
Explanatory Notes	Under 50 years of age Excessive concessional contributions also count towards the non-concessional contributions cap	Over 50 years of age and available until 30 June 2012 Excessive concessional contributions also count towards the non-concessional contributions cap	If under 65 years of age at any time during the year the contribution is made, two more years of contributions can be brought forward effectively allowing the member to contribute $450,000 at once, or at any time during three financial years.

contributions are in excess of the concessional contributions cap, the member is taxed at an additional 31.5% on the excess over and above the 15% already paid by the superfund.

The member can elect to have that amount released from the fund using a voluntary release authority rather than pay the tax personally. The excess contribution is also counted towards their non-concessional contributions cap.

Note however that the amount of the personal deduction will be limited by the member's taxable income. For example, Dr Sole is 51 and operates his practice as a sole trader. In the 2011 year, he is forecast to make $300,000 and plans to make a personal deductible contribution into superannuation of $100,000. Dr Sole can claim the entire contribution as a tax deduction because it does not exceed his taxable income. The $50,000 excess ($100,000 contribution less concessional cap of $50,000) will be taxed at 46.5% (15% contributions tax plus 31.5% penalty tax) and will also be counted towards his non-concessional contributions cap.

From column 3 of Table 2 it can be seen that if a contribution exceeds the non-concessional contribution cap, the member is taxed an additional 46.5% on the excess.

In the case of excess concessional contributions, the member may choose to pay themself or release an amount from the fund to cover the tax liability. However penalty tax on exceeding the non-concessional contribution cap must be paid from out of the relevant member account by using a compulsory release authority.

You can see from columns 1 and 3 of Table 2 that if a member breaches both the concessional and non-concessional contribution caps, the effective tax rate on the excess could be as high as 93%!

Keeping within the Concessional Contributions labyrinth

Your desire to optimise your contributions and financial planner's recommendations to make additional contributions is all well and good. Ultimately the responsibilities are often pushed back onto you to monitor your concessional contributions to ensure these do not exceed your cap limits. This is risky as it is not as straight forward as it seems in determining what concessional contributions have already been made in any given year, let alone what may yet be made in the remainder of the financial year.

Super Guarantee

Salary sacrifice, super guarantee contributions and treatment of bonuses can come into critical play for dentists (or their employees) who have structured their remuneration as wages and salaries within a corporate practice structure.

Dr Corp, aged 51, has stuck with various traditional wisdoms and continues to operate under his old corporate structure. He conservatively controls his cash flow by drawing a set salary and, towards the end of each financial year, decides what bonus he would like to draw depending on how well his practice has done. He always likes to salary sacrifice a sufficient proportion into super without breaching his concessional contributions caps.

He pays himself $200,000 per annum. His quarterly salary is $50,000. When calculating super guarantee, it is important to note that SG contributions are limited to ordinary time earnings up to a maximum of $42,220 per quarter for the 2010/2011 year. As such, Dr Corp's quarterly salary exceeds the maximum contribution base and therefore SG payable is $3,800 per quarter (9% of $42,220 not $50,000) . His total concesssional contributions for 2011 will therefore initially stand at $15,200 of SG all other things remaining static.

Based on his numbers to the end of March, his appointment book and his forecast for the rest of the year, he determines an additional $100,000 should be drawn. SG will not also be paid on this amount as the max SG threshold has already been passed. Total concessional contributions for SG for 2011 will remain at $15,200.

Consequently, in March, Dr Corp commits to salary sacrificing $34,800 of his annual bonus straight into superannuation (i.e. not first paid to him) prior to 30 June 2011. This will bring Dr Corp's concessional contributions for 2011 to a total of $50,000, his concessional cap limit.

Personal deductible contributions

Dentists who are predominantly self-employed may be eligible for a deduction on personal contributions into superannuation. Essentially however, the eligibility for this deduction is determined by the 10% test. Changes to the legislation and ATO interpretation last year need to be considered together with other key factors affecting the eligibility of dentists to claim deductions on personal contributions whilst avoiding excess contributions complications.

The 10% test

The test applies if, in the year of the contribution, a member engages in activities that result in them being treated as an employee under the Superannuation Guarantee legislation.

The test requires that less than 10% of the member's assessable income plus their reportable fringe benefits total plus (for the 2010 tax year onwards) their reportable employer superannuation contributions (RESC) is attributable to their employment activities.

If a member fails the 10% test, any personal contributions made in the financial year are NOT deductible and are regarded by the Tax Office as non-concessional contributions, even if the client has provided a notice of intent to claim the contributions as a tax deduction to their super fund. If the client has otherwise reached their non-concessional contributions cap, this also means they may incur excess non-concessional contributions tax.

Changes in managing this test during the 2010 tax year onwards have arisen as a consequence of the inclusion of RESC into the 10% test calculation.

Dr Sole, aged 51, derives approximately $275,000 from his own sole practice. He chooses to boost his earnings by working part-time in another practice as an employee earning $35,000 gross.

Each year, he always decides to fully sacrifice his part-time salary into superannuation. In the past, this meant the 10% test was passed with flying colours as there was effectively no employment sourced income included in the calculation (i.e. $35,000 sacrificed into superannuation would not be included). He would like to make an additional $15,000 personal contribution to maximise the allowable $50,000 concessional contribution cap limit this year.

However, pursuant to the inclusion of RESC into the calculation, under the new rules the calculation will be as follows:

$$\frac{\text{Employment income + RESC + Reportable Fringe Benefits}}{\text{Total assessable income + RESC + Reportable Fringe benefits}} = \frac{\$35{,}000}{\$310{,}000} = 11.29\%$$

Whilst Dr Sole can salary sacrifice the $35,000 into superannuation, he will not be able to make the additional $15,000 personal contribution because he does not meet the 10% test. This is a wasted opportunity to maximise super contributions.

Worse still, if he has already contributed $15,000 into superannuation unaware of the adverse issue, he will incur additional personal tax of $6,975 when denied the deduction for personal super contribution of $15,000.

In addition, the disallowed personal contribution deduction of $15,000 will be treated by the Tax Office as non-concessional super contributions. If Dr Sole has already made the maximum $450,000 non-concessional contribution at some point within the last 3 years, then he will also have breached the non-concessional contribution cap as well. This will incur an additional excess contributions tax of 46.5%, viz $6,975 excess tax. Therefore, the total tax take in respect of the $15,000 contribution may be $13,950 or 93% of the $15,000 contribution!

The 10% test - some solutions

You will see from the earlier example that Dr Corp would not face this limitation should he choose to also engage in additional part-time employment as he already draws a salary from his corporate practice. As such, if Dr Sole also incorporated his dental practice and drew a salary like Dr Corp, he too could have his own company contribute the $15,000 balance of his concessional superannuation cap.

Note that there are a number of cost, tax and other structural considerations to take into account before determining that the corporate solution should in fact be pursued. Some of these issues have been touched on in a previous article *Goodwill Hunting* in the Sept/Oct 2008 edition.

What if Dr Sole had utilised a service trust in running his practice? Commonly such service trusts typically make large distributions to other family members on lower marginal tax rates. This of course is an oversimplified summary of their operation and for a more detailed analysis of their operation you should refer to *Service Entities - Back to the Future* in the Jan/Feb 2008 edition.

In Dr Sole's case, had $42,000 been diverted via a service trust to family members on a 31.5% marginal tax rate, the tax take would have been $6,300 less had $42,000 been derived by Dr Sole. However whilst Dr Sole would have paid $19,530 in tax at the highest 46.5% tax rate, the additional $42,000 non-employment income would have resulted in his passing the 10% test:

$$\frac{\text{Employment income + RESC + Reportable Fringe Benefits}}{\text{Total assessable income + RESC + Reportable Fringe benefits}} = \frac{\$35,000}{\$352,000} = 9.94\%$$

This therefore means that Dr Sole would have also enjoyed a $6,975 tax benefit on the full $15,000 personal super contribution which he would not otherwise have been able to make. Accordingly, it should be remembered that typical tax distribution strategies should sometimes be reconsidered rather than always slavishly followed each year.

Insurance premiums

Many people hold their insurance policies, such as life and total or permanent disability, within their superfund. They use their personal deductible super contributions to fund the otherwise non-deductible premiums for their cover.

As seen above, personal superannuation contributions will count towards their concessional contributions cap and in addition to the 15% contributions tax, any excess will attract the 31.5% penalty tax rate. However, an interesting twist is that contributions used to fund insurance premiums will not attract the initial super funds 15% contributions tax.

You will recall that in our first example, Dr Corp ran a corporate practice, was aged 51, is on the highest marginal tax rate of 46.5% and has already contributed his maximum concessional personal super contribution of $50,000. He wants to maximise his super contributions each year but as he still has practice debt and highly geared investments, he has substantive life cover and his annual premiums run to $2,000 pa. Is he better off planning to put his policy in or outside super? The practical opportunity this presents is outlined in Table 3.

Table 3. Insurance premiums and super funds

Life Cover Outside Superannuation	
Gross Practice Salary	$3,738
Income Tax @ 46.5%	-$1,738
Net Practice Income to cover premiums	$2,000
Net Cash remaining	**NIL**
Life Cover Inside Superannuation	
Salary Sacrifice Contribution	$3,738
Life insurance premium	-$2,000
Contributions tax $1,738@ 15%	-$260
Excess concessional tax $3,738 @ 31.5%	-$1,177
Net Superannuation Benefit remaining	**$301**

Notwithstanding that Dr Corp has made excessive contributions and incurred the 31.5% penalty tax, he is still $301 better off salary sacrificing additional contributions into superannuation because the excessive portion has been used to fund insurance premiums.

Keeping within the Non-Concessional Contributions labyrinth

You will recall that Column 4 of Table 2 outlined the amount of non-concessional contributions a person can make without incurring penalty tax. It can be seen that the annual non- concessional cap is $150,000 per person but that a non-concessional contribution up to $450,000 can be made if the member is less than 65 years of age at any time in a particular financial year. These "bring forward" provisions also allow the $450,000 non-concessional contribution to be made over the course of three financial years.

The Bring Forward Rule

However, if over 65 years of age at the time of so contributing, it is essential to meet the work test (having worked at least 40 hours in 30 consecutive days) before the contribution is made. It is also important to note that once more than the annual non-concessional cap of $150,000 is contributed, then the bring forward provisions are automatically triggered and $450,000 is the cap limit that applies for that and the following two financial years.

> *"The incentives for small business owners to become self-funded retirees are embodied in a number of capital gains tax exemptions and discounts available when they dispose of their business or business assets..."*

For example, Dr Retire turned 65 years of age in September 2010. He plans to continue to work in his practice until the end of 2012. He has just made a $200,000 non-concessional contribution in January 2011 as he was cashed up having just sold an investment property and was keen to ramp up his superannuation investment.

He correctly did so as he had turned 65 during the 2011 tax year. As the contribution exceeds the annual $150,000 limit he has triggered the bring forward rules and therefore can make up to another $250,000 of additional non-concessional contributions during the 2012 and 2013 financial years.

However, he needs to plan the timing of future non-concessional contributions. Whilst he will be able to make additional contributions during 2012, as he will continue to meet the work test, his retirement at the end of that year poses a problem. As he will be retired during the 2013 tax year, he will not pass the work test and will be unable to make additional contributions during the 2013 tax year notwithstanding it is one of the three years of his bring forward period.

Small business tax concessions

The incentives for small business owners to become self-funded retirees are embodied in a number of capital gains tax exemptions and discounts available when they dispose of their business or business assets. The operation of these CGT concessions has been outlined in previous articles such as *Goodwill Hunting* in the Sept/Oct 2008 edition. However, the focus here will be on some of the superannuation benefits associated with their application as well.

If Dr Retire succeeded in selling his practice, how best could he handle the proceeds from the sale on retirement? What final superannuation optimisation strategies present themselves?

Let's assume that Dr Retire sells his practice for $1 million in the 2011 financial year but negotiated to continue working as a contractor Associate to the purchasing dentist until 30 June 2012. He bought his practice in 1995 for $600,000. Dr Retire has made a $400,000 capital gain but it will be exempt from tax as Dr Retire has run the practice for just over 16 years and will therefore be eligible for the small business 15-year exemption.

This CGT exemption also carries a superannuation benefit in the form of excluding a superannuation contribution equal to the entire sale proceeds from the non-concessional contributions cap. There is a maximum lifetime CGT cap limit of $1.155 million but Dr Retire is under that limit having never utilised it in previous years. Therefore, Dr Retire can contribute the full $1million sales proceeds received into superannuation without using up any of the otherwise restrictive superannuation contribution caps.

A different outcome would arise if Dr Retire had bought his practice as late as 1998. In this circumstance, he will not be able to claim the 15 year CGT exemption. He is therefore unable to contribute the full sales proceeds of $1 million as before. However he may still avail himself of the following CGT small business concessions (set out in Table 4) which will operate to reduce both his personal tax bill as well as optimise his superannuation investment strategy.

Unlike the more generous 15-year retirement exemption, the contribution permitted under the CGT cap, where the CGT retirement exemption applies, is limited to the net capital gain exempted. Dr Retire will therefore maximise this at $200,000 under strategy 2 by not applying the active asset discount. Strategy 1 limits the permitted contribution to $100,000 by also applying the active asset discount. It is one of those occasions when less is in fact more!

The $200,000 retirement exemption contribution does not count towards his non- concessional super cap. Therefore Dr Retire is still also able to make his planned $250,000 non-concessional contribution during the 2012 tax year, representing the remaining balance of the bring forward he crystallised when making the $200,000 non-concessional contribution in January 2011.

Table 4. CGT small business concessions

	Strategy 1	Strategy 2
Sale Proceeds	$1,000,000	$1,000,000
Capital Gain	$400,000	$400,000
General 50% discount	-$200,000	-$200,000
Active asset discount	-$100,000	Not applied
CGT retirement exemption	-$100,000	-$200,000
Income tax payable	NIL	NIL
CGT non-concessional exemption contribution	$100,000	$200,000

Traps leading to excess concessional and/or non-concessional contributions

Like a labyrinth, it is often difficult to get an overview once wending your way through it. Whilst not necessarily an exhaustive list, what follows summarises some of the major traps and errors which have been highlighted in this article.

Concessional contributions:

- Remember to ensure you pass the eligibility requirements of the 10% test before making personal deductible contributions;
- Do not forget that SG contributions are included in the cap calculation;
- Remember that contributions are counted in the financial year in which they are received so check the timing of June payments. They may not necessarily be included in the preceding year but in the current year cap calculations; and
- Remember that contributions paid into superannuation to fund insurance premiums are still counted towards the concessional contributions cap.

"It is not the responsibility of employers or trustees to monitor your contribution levels. Advise your planner and/or tax accountant as to your contribution intentions as you may well need to explore alternative arrangements. You do not want to end up with effective tax rates of up to 93%!"

Non-concessional contributions:

- Remember to check both concessional and non-concessional contributions made to all superannuation funds in the current and preceding two financial years to ensure no accidental crystallisation of the bring forward rules has already occurred;
- Do not forget excess concessional contributions count towards the non-concessional cap;
- If you are turning or have previously turned 65 years of age, ensure you determine your eligibility to contribute prior to considering the caps;
- Denial by the Tax Office of all or part of a personal super contribution is counted as a non-concessional contribution;
- Ensuring the paperwork is in order. For example, an incomplete notice of deductibility on a personal contribution will count as a non-concessional contribution if rejected by the fund trustee; and
- Ensuring not to make non-concessional contributions in excess of the small business CGT caps where the very different 15 year or retirement exemptions are met.

In conclusion, it is important to again emphasise that it is not the responsibility of employers or superfund trustees to monitor your contribution levels. Remember to advise your planner and/or tax accountant as to your contribution intentions as you may well need to explore alternative arrangements if you are seeking to optimise your taxation and superannuation investment strategies. You do not want to end up with effective tax rates of up to 93%!

Disclaimer

This article is designed to provide generic information only and should not be viewed as a recommendation to act. Individuals should seek advice from a qualified advisor to ensure their actions are commensurate with their financial needs and requirements.

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