CTC ACCOUNTANTS

TAX & BUSINESS SERVICES

SMSF NEWSLETTER

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SPECIAL POINTS OF INTEREST:

1. **'Dividend washing' in the spotlight**
2. **Recent developments mean potential tax windfall**

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LATEST ON 'DIVIDEND WASHING' AND SMSFS

The ATO won a court battle with an SMSF regarding whether 'dividend washing' is tax avoidance. This article discusses recent developments for SMSFs undertaking the 'dividend washing' strategy.

Background – Franking credits and SMSFs

Franking credits represent a refund of company tax paid. They are valuable to an SMSF because the refundable tax credits (at a rate of 30%) exceed the tax rate payable by an SMSF (generally 15%, or 0% on assets supporting a pension).

'Dividend washing' is a strategy to access two franked dividends on one parcel of shares by selling shares and then repurchasing them quickly on a separate ASX 'special' market.

SMSFs profited from this strategy because the extra franking credits could reduce (or even eliminate) tax payable by the fund.

Due to the risk to the revenue, a law change was made by the government whereby participants in 'dividend washing' will now lose the franking credits on the second dividend.

How does 'dividend washing' work?

In the context of an SMSF, dividend washing works as follows:

Step 1 – SMSF receives a dividend

Your SMSF receives a dividend on shares owned at the 'ex-dividend' date. Note, if your SMSF buys shares after this time – it will not receive a dividend because the vendor has the dividend entitlement.

Step 2 – Sell existing shares

The shares are then sold once they go 'ex-dividend'. Your fund remains entitled to a dividend because it owned the shares on the 'ex-dividend' date.

Step 3 – Re-purchase shares on the ASX 'special' market

After selling the shares, your SMSF then immediately buys a new parcel of shares on the 'ASX Special Market'. This special market is open for two days after a share goes ex-dividend. The market operates independently of the ASX and was established to assist with timing problems encountered with particular securities transactions.

In contrast to the 'normal' ASX market where the **vendor** receives the recent dividend – for shares purchased through the special market, the **purchaser** is entitled to the dividend.

Structuring a transaction in this way means that your SMSF receives a dividend on the same shares twice – **once** on the original shares, and a **second** dividend on the parcel purchased on the ASX special market.

'Dividend washing' law change

The government amended the law from 1 July 2013 to disallow a taxpayer (including an SMSF) from claiming the franking credits on the second dividend received under a 'dividend washing' arrangement.

That is, your SMSF can still participate in 'dividend washing' – however, the downside is that your fund loses the franking credit on the second dividend.

Court finds 'dividend washing' is tax avoidance

A court case recently considered whether dividend washing entered by an SMSF into before 1 July 2013 (i.e. when the law changed) was tax avoidance.

The Tribunal confirmed that the transactions were tax avoidance. The sale and re-purchase of the shares were only profitable because of the franking credits received. Therefore, the fund was denied the franking credits on the second dividend.

"It discusses SMSF members drawing down a transition to retirement income stream (TRIS) and potentially saving tax on their pension income"

"Unless you satisfy the 'retirement' condition of release, or attained age 65, you cannot use this strategy to access superannuation above your 10% cap"

TAX FREE PENSION INCOME

The ATO have recently published guidance about transition to retirement income streams (TRIS). In this article we discuss potential tax savings if you are under 60 and receiving a TRIS or account-based pension.

Background – tax free pension income

If you are aged between preservation age (currently 56) and 59, pension payments are generally taxed as follows:

- **Tax free component** – tax exempt in your hands; and
- **Taxable component** – subject to tax, with a 15% offset.

In contrast, lump sums drawn down from your pension account are taxed as follows:

- **Tax free component** – tax exempt in your hands; and
- **Taxable component** – tax exempt up to your indexed, lifetime 'low rate cap' ($195,000 for the 2016 income year).

To summarise, the tax free component is tax exempt for both lump sums and pension payments. However, the taxable component of a lump sum is tax exempt up to the cap, whereas a pension payment is taxable. Hence, the taxable component can be more concessionally taxed as a lump sum compared to a pension payment.

EXAMPLE–Judith, aged 59, currently draws down an account-based pension (ABP) from her SMSF (all taxable component). She must draw down a minimum pension payment of $35,000 from her fund. Her options are:

- **Pension payment** – assessable from dollar one, with a 15% offset.
- **Lump sum** – tax free.

Hence, if Judith drew down a lump sum instead of a pension payment, the payment would be tax free up to her lifetime cap of $195,000 (2016 income year). Assuming Judith's tax rate is 32.5% (ignoring Medicare), she saves tax up to **$11,375** (i.e. $35,000 x 32.5%).

Lump sums and a TRIS

Traditionally, it has been understood that this strategy only works with an account-based pension. This is because the superannuation laws generally do not permit you to draw down a lump sum from a TRIS.

However, the ATO recently commented that a member receiving a TRIS can elect for a pension payment to be a 'lump sum' for tax purposes. The advantage of making an election is that the taxable component of the payment is tax free up to the $195,000 life time cap, as noted above.

Importantly, electing to treat a pension payment as a lump sum only applies for tax purposes. Hence, your fund should not breach the superannuation laws for a TRIS simply by choosing to treat the pension payment as a lump sum.

INFO–The tax laws only allow you to treat a pension payment as a lump sum if you make a written election to do so beforehand.

Other information

You need to be aware of the following:

- Unless you meet a full condition of release (e.g. retirement), you cannot use this strategy to access superannuation above your 10% cap;
- A pension payment for a TRIS must still generally be paid in cash. It cannot be satisfied by way of a property transfer (i.e. 'in specie') – even if you elect to treat it as a lump sum (i.e. as outlined above); and
- The ATO have stated that this election may impact on the pension exemption.

EXAMPLE–Noah, aged 57, is still working and drawing down a TRIS with a balance of $400,000. The underlying balance is all preserved, and comprises solely of the taxable component. Noah can elect beforehand for the payment to be a lump sum for tax purposes. The payment will be tax free up to his low rate cap ($195,000 for the 2016 income year).

Contact Us

ctc@ctcaccountants.com.au

www.ctcaccountants.com.au

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