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Critical issues in managing excess contributions

Following the introduction of more limited contribution caps from July 2007, many SMSF members are now facing hefty excess contributions tax assessments. With a further substantial reduction of the concessional contributions caps for the 2009-10 year onwards, this problem is likely to continue.

Excess contributions assessments can be disastrous. Excess non-concessional contributions are taxed at 46.5%, while excess concessional contributions are taxed at 31.5% (on top of the usual 15% tax). Sometimes, this problem is exacerbated because excess concessional contributions automatically count as non-concessional contributions and can push a member into excess concessional *and* non-concessional territory. In this case, a marginal tax rate of 93% applies.

This edition of DBA news examines a particularly thorny problem in managing excess contributions that all advisers should be aware of, and a possible strategy to deal with this issue.

The problem

In practice, excess non-concessional contributions are causing far more headaches than excess concessional contributions. (In fact, some members may seek to exceed their concessional contributions cap if they are already on the top marginal tax rate.) The *Superannuation Industry (Supervision) Regulations 1994* (Cth) ('SISR') impose some obligations on trustees to return excess non-concessional contributions, which sounds like good news. However, these regulations have been interpreted narrowly and this has severely limited the ability to return excess contributions.

Specifically, reg 7.04(4) of the SISR broadly requires a trustee to return contributions that are received above a person's non-concessional contributions cap. However, the ATO has stated their view in ID 2007/225 that a member must make a contribution that *in itself* exceeds their non-concessional contributions cap in order for reg 7.04(4) to apply. The ATO states that a trustee is not required to add up the total of all contributions received.

Example

David is 58 years old and makes the following non-concessional contributions to his SMSF in 2009–10:

contribution		running total
$100,000	*in July 2009*	$100,000
$200,000	*in Oct 2009*	$300,000
$200,000	*in May 2010*	$500,000
$150,000	*in June 2010*	$650,000

David has clearly exceeded his cap of $450,000. However, according to ID 2007/225, the SMSF trustee is not obliged by reg 7.04(4) to return any of these amounts because none of these, on their own, exceed his cap.

Even though the third contribution would put him over, the trustee is not obliged to return it. Furthermore, even though he is already well into excess territory before he makes the fourth contribution, there is still no obligation to return it. The only grounds for returning an amount would be if David made a single contribution that in itself exceeds $450,000.

While there are sound arguments that this interpretation of the SISR is incorrect, the ATO is likely to follow its view in ID 2007/225.

How do these problems arise?

Unfortunately, even members who are very careful are accidentally exceeding their caps. In practice, problems can arise where, for example:

- members simply forget about earlier contributions made in the same financial year;
- members misjudge their eligibility under the 10% rule to deduct personal contributions (which means amounts intended as concessional contributions end up being non-concessional contributions); or
- timing issues result in amounts being contributed on the wrong side of 30 June (eg, sale proceeds from an asset sold outside super are received late, or amounts are accidentally transferred too early). The month of June is typically hectic and mistakes often occur in the rush to make contributions.

The SMSF governing rules can play a role

Ideally, the best solution is to be proactive and ensure, as far as possible, that SMSF members do not make excess contributions. However, even with sound professional advice, many SMSF members are still accidentally landing in hot water.

When there is no regulatory obligation to return an excess contribution, most SMSF trustees will have no other basis for returning amounts. Many SMSF governing rules unfortunately have inadequate provisions to deal with contributions. For example, many simply require the trustee to only accept amounts in accordance with the current law or regulations, which does not add anything (especially in light of ID 2007/225).

SMSF trustees can therefore benefit by ensuring they have prudently drafted governing rules that require contributions to be returned beyond the narrow circumstances required by law, eg, by requiring the trustee to add up *all contributions* received before determining whether to accept an amount. Can governing rules do this? The answer is 'yes':

- The SIS legislation provides that the governing rules cannot seek to exclude or modify the SIS legislation. Such provisions do not do this; they merely add additional obligations for the trustee. All SMSF governing rules contain additional powers and obligations that supplement the SIS.
- This is consistent with the policy behind contributions caps, which is 'to ensure that the amount of concessionally taxed superannuation benefits that a person receives results from superannuation contributions that have been made *gradually over the course of the person's life*'. SMSF governing rules which require the trustee to return amounts that would place a member over their cap assist to prevent the mischief the laws are designed to prevent.

Can these provisions be retrospectively inserted?

On balance, no. Case law tells us that provisions can be validly inserted into the terms of a trust, provided the amendment power is sufficient. On its face, it appears a trustee could wait until an excess contribution issue arises before inserting such a provision. However, consider the following:

- Although such a retrospective amendment would be effective against the beneficiaries, it is unlikely to be effective against the Commissioner of Taxation.
- Such a retrospective amendment would result in the member's benefits decreasing and could arguably be a contravention of the SIS rules that require minimum benefits to be maintained.

Thus, SMSF trustees should ensure their governing rules contain sound provisions for dealing with excess non-concessional contributions and it is preferable these are in place *before* a problem arises.

All SMSFs subscribed to DBA's Annual Update Service (as part of the 1 July 2009 update) and all other SMSF governing rules prepared by DBA Lawyers after that date already have these provisions.

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