CARISMA SOLUTIONS

TYPES OF INCOME FROM SMSF

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Types of Income - Introduction

Income from a Self-Managed Super Fund (SMSF) encompasses various streams of revenue generated by the fund's investments.

This includes:

- Interest Income: Earnings from cash and term deposits.
- Trust Distributions for Unit Trust Investments
- Dividends: Earnings from shares held within the SMSF.
- Rental Income: Earnings from real estate properties owned by the SMSF.
- Capital Gains: Profit from the sale of investments such as shares, property, or other assets.

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Types of Income - Introduction

Pension Income: This includes:

- **Income Streams**: Regular payments made to members in retirement, often from a pension account within the SMSF.

Contributions: Although not income in the traditional sense, contributions to the SMSF include:

- **Concessional Contributions**: Pre-tax contributions such as employer contributions and salary sacrifice.
- **Non-Concessional Contributions**: After-tax contributions made by members.

Government Payments: This could include:

- **Government Co-Contributions**: Payments made by the government to eligible SMSF members based on personal contributions made to their superannuation.

- **Investment Returns**: For specific investment vehicles like managed funds or unit trusts within the SMSF, the returns might be classified as income.

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Interest Income

Interest income from a Self-Managed Super Fund (SMSF) typically comes from cash investments and term deposits.

Types of Interest Income

1. **Cash Accounts**: Interest earned on funds held in savings or transaction accounts within the SMSF.
2. **Term Deposits**: Interest earned from fixed-term deposits where the SMSF has invested its funds.

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Interest Income - Considerations

Compliance Considerations

Investment Strategy: The SMSF's investment strategy must reflect its approach to managing cash and term deposits. The strategy should be reviewed regularly to ensure it aligns with the fund's objectives.

Documentation: Maintain detailed records of all interest income received, including bank statements and term deposit certificates**.**

Other Considerations

- **Liquidity:** Holding cash and term deposits can provide liquidity to the SMSF, which can be important for meeting pension payments or other fund obligations.
- **Risk and Return:** While cash investments are low risk, they generally offer lower returns compared to other asset classes. This should be balanced with the SMSF's overall investment strategy and risk tolerance.

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Trust Distributions Unit Trust - Investments

Unit Trust Overview

- **Unit Trust**: A unit trust is a form of investment vehicle where investors hold units in the trust, and income is distributed to unitholders based on the number of units they hold. This structure is often used for pooling investments.
- **Unit Trust Investment**: An SMSF may invest in a unit trust, and in return, it receives units in the trust. The trust then distributes income (e.g., dividends, interest, capital gains) to the unit holders.

Trust Distributions to SMSF

- **Income Distribution**: The unit trust will distribute income (such as interest, dividends, or rental income) to the SMSF based on the number of units the SMSF holds. These distributions are usually made on a regular basis, such as quarterly or annually.
- **Capital Gains Distribution**: If the unit trust realizes capital gains, it may distribute these gains to its unit holders. These distributions are usually made at the end of the financial year or when the trust liquidates some of its investments

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Trust Distributions - Reporting

Reporting and Tax

- **Financial Statements**: The SMSF needs to include the income distributions from the unit trust in its financial statements.
- **Tax Returns:** Distributions received from the unit trust must be reported in the SMSF's annual tax return. The tax treatment of these distributions will depend on whether the SMSF is in the accumulation or pension phase.

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Dividends

Dividend income is an important component of many Self-Managed Super Funds (SMSFs), especially those that invest in shares or other equity-based securities.

Types of Dividend Income

1. **Fully Franked Dividends**: Dividends that come with a franking credit, indicating that the company has already paid tax on the profit at the corporate tax rate (currently 30% in Australia).
2. **Partially Franked Dividends**: Dividends where only part of the profit has been taxed at the corporate rate, with the remaining portion being unfranked.

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Dividends - Investment Strategy

- **Diversification**: Dividend income can be an important part of an SMSF's strategy for generating regular income. Diversifying investments to include a range of dividend-paying stocks can help manage risk and achieve stable returns.

- **Reinvestment**: Consider whether to reinvest dividends back into the SMSF's investments or distribute them as part of the fund's income stream, depending on the fund's strategy and members' needs.

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Dividends - Other Considerations

- **Dividend Imputation System**: Australia's dividend imputation system helps avoid double taxation of corporate profits by allowing companies to pass on credits for the tax already paid. This system benefits SMSFs by reducing the effective tax rate on dividend income.
- **Market Risk**: Investing in dividend-paying stocks carries market risk, and the amount of dividend income can fluctuate with market conditions. It’s important to align such investments with the SMSF’s overall risk tolerance and investment objectives.

Rental Income

Rental income is a significant component for SMSFs that invest in real estate.

Types of Rental Income

1. **Residential Property**: Income derived from renting out residential properties owned by the SMSF.
2. **Commercial Property**: Income from leasing commercial properties, such as office spaces, retail stores, or industrial buildings.
3. **Industrial Property**: Rental income from industrial facilities or warehouses.

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Rental Income - Compliance Considerations

1. **Arm's Length Principle**:

   - All rental agreements must be at market rates and on commercial terms to comply with the SMSF's arm's length rule. This means transactions should be conducted as if they were between unrelated parties.

"**Arm's length**" refers to transactions or dealings that are conducted as if the parties involved were unrelated, ensuring fairness and market value.

2. **In-House Assets**:

   - SMSFs must avoid investing in property owned by related parties unless certain conditions are met. The property must be an arm's length transaction and must not provide any personal benefits to members or their relatives.

3. **Borrowing:**

   - If the SMSF borrows to purchase the property, ensure compliance with the Limited Recourse Borrowing Arrangement (LRBA) rules. The property must be held in a separate trust (bare trust) and income must be used to service the loan.

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Rental Income - Other Considerations

1. **Market Conditions**:
    - Be aware of market conditions that might affect rental income, such as changes in property values or rental demand.
2. **Maintenance and Upgrades**:
    - Regular maintenance and strategic upgrades can help maintain or increase rental income and property value.

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Capital Gains

Profit from the sale of investments such as shares, property, or other assets.

Capital gains income from a Self-Managed Super Fund (SMSF) arises from the sale of assets, such as shares, real estate, or other investments, where the selling price exceeds the purchase price.

There are two types of taxable income: income of a **revenue nature** and income of a **capital nature**.

Note that capital losses can’t be offset against revenue gains for the calculation of taxable income.

Capital losses are quarantined and can only be utilised against capital gains.

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Capital Gains - Types

Types of Capital Gains

1. **Real Estate**: Gains from the sale of residential or commercial properties.
2. **Shares and Securities**: Gains from selling stocks, bonds, or other equity securities.
3. **Other Investments**: Gains from the sale of other investment assets, such as managed funds or collectibles.

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Capital Gains -Compliance Considerations

1. **In-House Assets**:
   - Ensure that the sale of assets involving related parties adheres to the arm's length principle and does not breach SMSF regulations regarding in-house assets.
2. **Borrowing**:
   - If assets were purchased using borrowed funds (under a Limited Recourse Borrowing Arrangement, or LRBA), ensure compliance with the relevant rules when selling the asset and managing any associated loan repayments.
3. **Capital Gains Calculations**:
   - Be meticulous in calculating capital gains, including adjustments for any improvements made to the asset or costs incurred in acquiring or disposing of it.

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Pension Income

- **Pension income** from a Self-Managed Super Fund (SMSF) refers to the payments made to members who are in the retirement phase of their superannuation journey.
- These payments are typically used to provide a regular income stream for retirees.

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Pension Income - Types

1. **Account-Based Pensions**:
    - Also known as a defined contribution pension, where payments are based on the account balance and the member's chosen payment frequency and amount.
2. **Transition to Retirement Pensions**:
    - Allows individuals who have reached their preservation age but are still working to draw a pension while continuing to contribute to their superannuation.
3. **Lifetime Pensions**:
    - Provide a guaranteed income for the lifetime of the member. However, lifetime pensions are less common and typically involve external providers rather than SMSFs directly.
4. **Fixed-Term Pensions**:
    - Provide payments for a fixed period of time. The duration is set at the start of the pension and payments are made according to this fixed term.

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Pension Income -Tax Treatment

1. **Pension Phase**:
    - **Tax-Free Income**: In the pension phase, investment income earned by the SMSF, including interest, dividends, and rental income, is generally tax-free. This makes it a favourable tax environment for members in retirement.

2. **Tax on Pension Payments**:
    - **Tax-Free**: Generally, pension payments made to members over 60 years old are tax-free. For members under 60, pension payments may be subject to tax at the individual's marginal tax rate, but the fund can provide a tax offset of up to 15% to reduce the impact.

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Pension Income - Regulatory Requirements

Minimum Drawdown Rates: SMSF members in the pension phase are required to withdraw a minimum amount each financial year, which is based on a percentage of their account balance.

These percentages are set by the government and vary depending on the member's age.

Adjustments: During periods of economic downturn or market volatility, there have been temporary adjustments to the minimum drawdown rates (e.g., temporary reductions due to the COVID-19 pandemic).

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Pension Income - Investment Strategy

Investment Strategy

1. **Income Generation**:
    - The SMSF's investment strategy should be aligned with the goal of providing a sustainable and adequate income stream for members in retirement. This may involve a mix of income-producing assets and growth assets.
2. **Risk Management**:
    - Managing investment risk is important to ensure the longevity of the pension payments and to protect the SMSF's assets.
3. **Liquidity**:
    - Ensure that there is sufficient liquidity within the SMSF to meet the required pension payments. This may involve holding some assets in more liquid forms, such as cash or short-term investments.

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Contribution as an Income in SMSF

Contributions income refers to the various types of contributions made to the fund. These contributions are crucial for growing the fund’s assets and providing retirement benefits to members.

These contributions can come from various sources and have different tax implications depending on their type and the member's circumstances.

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Contribution -Types

1. **Concessional Contributions**:
    - **Employer Contributions**: Mandatory contributions made by an employer on behalf of an employee (Superannuation Guarantee contributions) and any additional contributions made as salary sacrifice arrangements.
    - **Personal Deductible Contributions**: Contributions made from personal after-tax income that are claimed as a tax deduction.
2. **Non-Concessional Contributions**:
    - **Personal Contributions**: After-tax contributions made directly by the fund member, which are not claimed as a tax deduction.
    - **Spouse Contributions**: Contributions made by one partner into the superannuation account of their spouse, which can qualify for a tax offset.

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Contribution – Types

3. Government Contributions:

Co-Contributions: Government contributions made to the member’s superannuation account, subject to income and contribution conditions.

4. Spouse Contributions:

Spouse Contributions: Contributions made to a spouse's super fund, which may also qualify for a government tax offset under certain conditions.

5. Superannuation Splitting:

Splitting Contributions: Contributions (usually concessional) that can be split with a spouse’s superannuation fund.

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Contribution as an Income for SMSF -Tax Treatment

1. **Concessional Contributions**:
   - **Tax Rate**: Taxed at 15% within the SMSF. Contributions exceeding the annual cap are taxed at 30%, and excess amounts are included in the member's assessable income.
   - **Caps**: The concessional contributions cap for the 2024 financial year is $27,500.
   - For 2025, the concessional contributions cap is $30,000.00
2. **Non-Concessional Contributions**:
   - **Tax Rate**: Not taxed upon entry into the fund but excess amounts beyond the cap are subject to additional tax.
   - **Caps**: The non-concessional contributions cap for the 2024 financial year is $110,000, or up to $330,000 using the bring-forward rule.
   - For 2025, the non-concessional contribution cap is $120,000.00
3. **Government Co-Contributions**:
   - **Tax Rate**: Tax-free and paid directly into the member's superannuation account, subject to meeting income and contribution conditions.

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THANK YOU!