Use of Reserves in an SMSF

Summary

The creation of reserve accounts can be an effective strategy. A reserve can be used to fund anti-detriment payments, to time contributions above the contribution caps, to smooth investment returns, and to facilitate the transfer of assets between family generations.

What is a reserve?

A reserve is an account or accounts established within a superannuation fund where an amount is set aside to provide for future expenses and payments. They do not form part of an individual member's account balance, instead they are a separate account within the fund.

Amounts credited to a reserve can originate from a number of sources including the investment earnings of the fund, revaluation of fund assets, insurance proceeds and residual amounts from lifetime and life expectancy pensions.

Superannuation legislation allows fund trustees to maintain reserve accounts provided it is permitted by the trust deed. If a reserve account is created, the trustees must develop a reserving strategy to indicate how the reserves of the fund are to be used.

There is no guidance in the legislation on the form the reserve should take. This allows the strategy to be suitably specific or broad in nature, as required. When formulating a reserving strategy, areas for consideration may include:

- the purpose of the reserve account;
- an investment strategy for amounts credited to the reserve; and
- how amounts in the reserve will be used by the fund and fund members.

What are the benefits of a reserve?

There are many uses for reserves. Some of these benefits may include:

- Anti-detriment payments
- Flexible timing of contributions over financial years
- Preventing the sale of lumpy assets to pay benefits
- Intergenerational transfer of assets
- Paying off loans raised purposes of limited recourse borrowing arrangements

Contribution reserve

An SMSF may use a contribution reserve for the purpose of enabling contributions in excess of the concessional and non-concessional caps to be made to the fund. The use of the reserve in these circumstances is limited, as the contribution must be made in June of the financial year and then transferred to the member's account by 28 July of the next financial year. Also, it is possible to use this strategy a limited number of times as it may result in excess contributions in the second and subsequent years.

A contribution reserve can be useful where an employer or a person wishes to claim a concessional contribution of up to their concessional contributions cap for the current financial year and the next financial year.

Part of the contribution is credited to the member's account and the remainder is credited to the reserve in June of the financial year. By 28 July in the next financial year the contribution is allocated to the members account and it will count towards the member's cap for the financial year in which it is allocated, not the year in which the contribution is made to the fund.

Case Study

Mike (45) is self-employed and eligible to claim a personal superannuation contribution. His taxable income is high this financial year and he wishes to make the maximum concessional contribution to the fund. He makes a contribution of $50,000 in June and claims a deduction for the amount in his tax return for this contribution and claims the deduction in the financial year in which it was made.

An amount of $25,000 of Mike's contribution is credited to his account in the SMSF and the remaining $25,000 is credited to a reserve. It is credited to Mike's account by 28 July in the next financial year

Investment reserve

Investment reserves have long been used to smooth investment returns. When investment returns are high, a portion of the return is credited to the member's account and the balance is allocated to an investment reserve. This reserve can be used to increase future amounts credited to member's accounts when investment returns for the year are low or negative.

Case Study

The Jones SMSF achieves an actual investment return for the year of 10%. The trustees of the fund decide to credit 5% of this return to the account balances of all members, with the remainder allocated to a reserve.

The following year the SMSF achieves an investment return of 1%. The trustees of the fund decide to use part of the investment reserve to increase the amount credited to all members to 4%.

Intergenerational transfer of assets

Reserves are not allocated to individual member's accounts so do not form part of member's death benefits. The reserve account can therefore be retained in the fund and transferred to future generations over time.

Case Study

Harold has $2 million in his SMSF including $150,000 in a reserve account. He would like the proceeds of his fund to go to his adult son Luke who is not a member of the fund. When Harold dies, the reserve account does not have to be paid out to Luke as a death benefit. Instead, Luke can become a member of the fund and the reserve account can be allocated to him over time.

Provided the allocations are fair and reasonable and are less than 5% of Luke's interest in the fund they can be transferred without being assessed against the concessional contribution cap.

The above example not only saves Luke 15% in lump sum benefit tax, it also has the potential to prevent the sale of lumpy assets in the fund to pay the benefit.

Anti detriment reserve

A superannuation fund can increase a member's lump sum death benefit to reflect the contributions tax paid by the fund provided certain conditions are met. This increased payment is commonly referred to as an 'anti-detriment' payment.

Where an anti-detriment payment has been made by the fund a tax deduction may be claimed based on the amount of the increased payment. The challenge for SMSFs is that the increased death benefit payment must be obtained from sources other than from members' accounts.

To enable the anti-detriment payment to be made, the trustees may use amounts credited to a reserve account to fund the anti-detriment payment.

Paying off loans for purposes of limited recourse borrowing arrangements

Limited recourse borrowing arrangements involve the superannuation fund borrowing for purposes of acquiring an investment which is held in a holding trust until it is sold or the loan is paid off and the investment transferred to the fund.

Amounts credited to the reserve can be used to pay off the loan and reduce or extinguish the outstanding loan for purposes of the limited recourse borrowing arrangement.

Case Study

The Smith Superannuation Fund has borrowed $100,000 for purposes of purchasing a property under a limited recourse borrowing arrangement.

The fund has paid interest on the amount borrowed and has built up a significant reserve of $70,000 from the fund's income over the years.

The trustees decide to use $50,000 of the amount credited to the reserve to reduce the amount of the outstanding loan.