KordaMentha

Superannuation tax reforms – what does it really mean?

December 2016

The Superannuation tax changes have now been legislated. They come into effect 1 July 2017.

I have been reflecting on the practical implications of the changes and concluded the following:

1. The tax changes with respect to the capping of the tax-free Superannuation Fund income referrable to the $1.6 million of pension assets is now a mechanical issue. It is now law and the significant tax advantage that was available to self-funded retirees over the last 10 years since the scrapping of the Reasonable Benefit Limits in 2006 is over. We now need to live with this.

2. Preparatory steps with respect to the pension tax changes are important but compliance driven. I will help you co-ordinate the implementation of those steps to ensure appropriate documentation is in place in readiness for the changes, effective 1 July 2017.

3. *Most significantly, the real challenge of these changes is to integrate them into your asset succession planning and subsequent documentation.*

As a result of the final legislation being enacted we can now plan and implement your preparatory strategy with certainty.

Accordingly, the purpose of this Paper is to therefore:

1. Articulate the mechanical steps that need to take place between now and 30 June 2017; and

2. Raise with you the asset succession implications to provoke your consideration of the matters that we collectively need to address.

Having considered the legislation in its draft and now final form and pontificated on the issues there is no doubt that there is not a "one size fits all" strategy fix.

You really need to now engage in this process to ensure that you are ready for 1 July 2017!

Mechanical steps we need to implement

There are a number of mechanical steps we need to consider to ensure that you have adequately prepared for these forthcoming changes.

These are as follows:

Phase One – Gather Key Historic Information

1. Completion of 30 June 2016 Income Tax Returns and Accounts

In considering the impact of these changes on your specific circumstances, we need to deal with the most up-to-date information concerning your financial position.

Accordingly, you need to have your 30 June 2016 Personal and Entity Income Tax Returns and Accounts and your Self-Managed Superannuation Fund's Accounts and Tax Return prepared as soon as possible.

Please collate your source information so that this can be undertaken early in the New Year.

Your 30 June 2016 Self-Managed Superannuation Fund compliance information provides critical characteristics of your unique superannuation interests vital to determining the most appropriate strategy for you going forward.

2. Determine your Current Net Asset Position and Future Cash Flow

The strategy implications for assets outside the Superannuation System are just as important to consider, as it is for those assets within your Self-Managed Superannuation Fund. Make sure you understand the tax characteristics of both sets of assets. In addition, it is important that you consider your likely cash flow spend from 1 July 2017. This also may impact on your ongoing strategy. I need to understand if you have significant one off expenditure next financial year as this too will influence your strategy.

3. Locate and Review your Current Asset Succession Documents

As I have previously said, the biggest implication for these changes is with respect to your asset succession strategy. Accordingly, in preparation for a strategic planning meeting that we need to hold, please re-review your current asset succession documentation. This documentation includes your Wills, Powers of Attorney, Self-Managed Superannuation Fund Binding Beneficiary Nomination and Pension documentation.

It also includes confirming the Life Insurance cover you currently have.

Phase Two – Prepare for the Changes

1. Do not make further Contributions to your Self-Managed Superannuation Fund without Seeking Advice!

You need to determine whether or not you are going to make further non-concessional contributions prior to the rules changing on 1 July 2017. From that date, non-concessional contributions are not permitted for taxpayers who have in excess of $1.6 million in accumulated superannuation entitlements. The amount of concessional (i.e. tax deductible) contributions you are permitted to make decreases from $35,000 (if you are aged over 50) to $25,000 from 1 July 2017.

If you are contemplating making a personal contribution to superannuation in the current financial year (either a deductible or non-concessional contribution) please contact me prior to making that contribution to confirm its appropriateness.

The timing of contributions is now very important and may have other taxation implications.

2. Obtain a Listing of the Assets in your Superannuation Fund at 9 November 2016

As previously foreshadowed in the Exposure Draft, the final legislation confirms, for those in pension mode during part or all of the 30 June 2017 financial year, they should be able to take advantage of a "Mark to Market" rule in relation to the capital appreciating assets held within their Self-Managed Superannuation Fund.

This will permit selected assets within your Self-Managed Superannuation Fund to have their Capital Gains Tax Cost Base adjusted to its market value prior to 30 June 2017.

This is designed to eliminate the unrealised capital gains that have accrued on those assets to date, being subject to tax on realisation post 30 June 2017.

These rules are complex.

They only apply to assets held at 9 November 2016.

Accordingly, it is important that you obtain a printout of those assets held by your Self-Managed Superannuation Fund as at that date.

This printout needs to detail the cost of those assets.

I can then assist you to determine how we will apply the “Mark to Market” rules in your particular circumstances.

Consider strategic issues

This phase is like putting together a jigsaw of your financial circumstances and intentions.

We have gathered all of the pieces and we now need to carefully place them in the appropriate positions.

Immediate tax planning considerations

1. Can we Equalise Pensions between Members?

The Pension Transfer Cap of $1.6 million is a taxpayer by taxpayer test. Accordingly, one needs to consider for multiple member Funds whether one or both members have accrued superannuation entitlements on 1 July 2017 that will exceed the $1.6 million cap. If one member as at that date is below the cap, we need to consider how can we “equalise” or balance up each of the members so that each member is at or over the $1.6 million cap as at that date.

Equalisation will decrease the amount in the Accumulation Phase within the Superannuation Fund for each member and therefore decreasing the amount of Superannuation Fund income subject to tax post 30 June 2017.

2. Should we effectively Segregate Assets by having two Superannuation Funds?

From 1 July 2017, Taxpayers will only be permitted to have $1.6m supporting tax free pensions within Superannuation. Any excess accrued superannuation entitlements will need to be “rolled back” into Accumulation mode effective that date with the income derived by the SMSF on that proportion of assets subject to income tax within the Fund itself.

The proportion of the SMSF’s income subject to tax will be calculated by an Actuary but will effectively be the percentage of income referable to the accumulation entitlements as a percentage of the total entitlements within the Fund. For example, if in a two-member Fund both members each start with a $1.6 million pension ($3.2 million in total) and have $800,000 in accumulation, the amount of the income of the Fund subject to tax will be 20% (i.e. $800,000 divided by $4 million).

Clients have asked should we be considering specifically identifying assets that support the $1.6 million pension per member from 1 July 2017 and segregating those assets to isolate the tax-free income generated by those assets?

From 1 July 2017, the law does not permit the formal segregation of assets between accumulation and pension mode for Self-Managed Superannuation Funds where members have more than $1.6 million in assets on a member by member basis. That is, only one member needs to have more than $1.6 million of accrued superannuation entitlements to preclude the entire Fund from segregating assets.

A person can effectively however, create a pseudo segregation strategy by physically separating assets between two individual Self-Managed Superannuation Funds.

That is, you can have a “Pension Only” Fund with for example, for two members funded with say $3.2 million of assets and the balance of the assets of the members in an “Accumulation Only” Fund.

The Pension Fund having members with 100% of the assets supporting pension liabilities will therefore produce 100% tax-free income.

The Fund will still be required to pay a minimum pension payment per annum, with that percentage dependent upon the age of the member on 1 July each year.

To determine whether or not you wish to create a dual Fund strategy post 1 July 2017 and therefore segregate assets you need to consider:

a. The cost of maintaining that structure; and

b. What type of assets do you wish to put in to support the pension?

This is you need to effectively try and pick winners with the assets that you are going to put in the tax-free Pension Fund punting their value will grow at a faster rate than those assets in the Accumulation Fund.

Asset succession issues

1. What are the Tax Characteristics of the Components of your Pension?

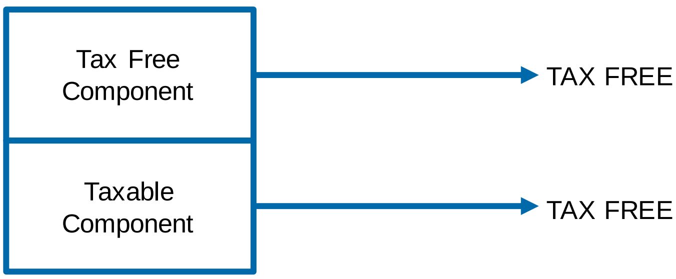
For those currently over 60 years of age, both pension income and lump sums withdrawn from the Superannuation system can continue to be accessed tax-free.

It is however on the death of a member that the underlying components of a Member’s Account are critical for determining the taxation consequences for the surviving beneficiary receiving the death benefit payment from a Superannuation Fund.

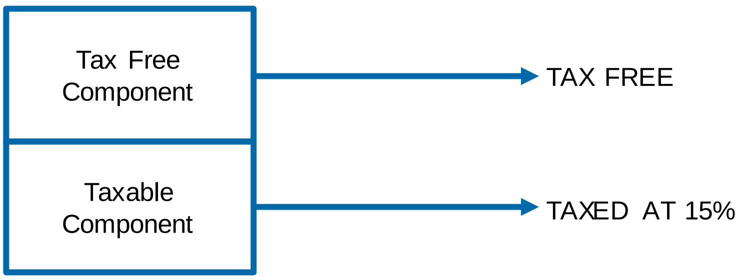
In general terms the taxation treatment of death benefits paid from a Superannuation Fund are as follows:

Taxation Consequences of a Death Benefit Payment from a Superannuation Fund

(a) Payment made to Spouse/Child under 18



(b) Payment to Child aged over 18/Non-Dependant



For a pension the apportionment between Tax-Free and Taxable components is set at the start of the pension and continues for the entire life of that pension.

For some clients, we have been able to establish multiple pensions with different taxation components.

You may have a pension with a 100 % Tax-Free component and another pension with a mixture of taxable and tax-free components.

The question to ask in establishing your complying pension up to the $1.6 million Pension Transfer Cap on 1 July 2017, is what are the optimal components to maintain within that pension?

The answer to this question depends upon the following factors:

a. The expected growth in the underlying assets within that pension; and

b. The age of the pensioner. The older the member, the higher the percentage of income that needs to be withdrawn annually from the Fund in the form of a pension.

In essence, if you believe the growth in the assets within your Fund will exceed the percentage of cash you need to withdraw per annum to meet the minimum pension payments, then your complying pension from 1 July 2017 should be sourced with the highest tax-free component.

It is possible over time to change the elements of your complying pension.

This can be done by commuting one pension that may have certain tax characteristics and commencing another with different characteristics.

2. Post 1 July 2017 what happens on the death of a Member to his or her pension?

Typically for clients with a spouse, where a person wished to bequeath their entire accrued superannuation entitlements to the other spouse, we have effected this by making each spouse a Reversionary Beneficiary of the other spouse's pension. As a Reversionary Beneficiary of a pension the benefits reverting to the surviving spouse can be maintained within the concessionally taxed superannuation environment until the death of the surviving spouse.

These rules have now changed effective 1 July 2017, which requires a rethink of your asset succession strategy on the death of the first spouse.

From 1 July 2017, you can only fund a pension up to the Pension Transfer Cap up to the limit at the time that you start that pension.

On 1 July 2017, this limit has been set at $1.6 million.

When your spouse dies and you are the Reversionary Beneficiary of his or her pension, you cannot access this cap twice.

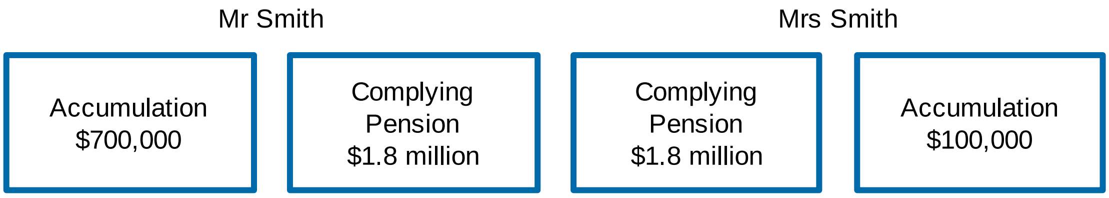
However, there is a work around.

Consider the following example:

> *Mr and Mrs Smith have a complying Self-Managed Superannuation which on 1 July 2017 they start pensions, each of them with $1.6 million of assets.*
>
> *They also have amounts in excess of the $1.6 million pension that will revert to Accumulation mode.*
>
> *A couple of years later, Mr Smith dies, providing his complying pension to Mrs Smith as the Reversionary Beneficiary.*

Diagrammatically on the death of Mr Smith his position would be as follows:

Possible Asset Succession Strategy Post 1 July 2017
Position on Death



Mrs Smith already has her own complying pension and as such the receipt of Mr Smith's pension as the Reversionary Beneficiary will prima facie put her over the Transfer Balance Cap.

She has 12 months however to sort out arrangements to come up with a strategy not to exceed the Cap.

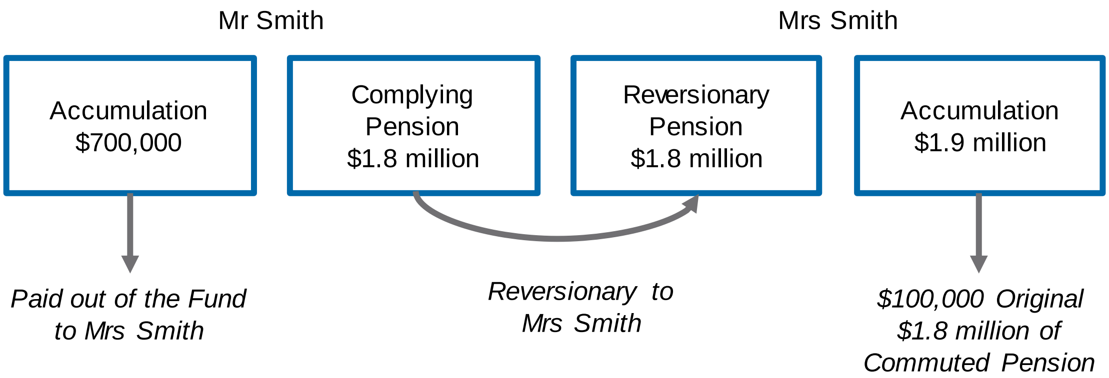
She could at this point withdraw tax-free all of Mr Smith's accrued superannuation entitlements which have grown to $2.5 million. Alternatively, to keep more assets within the Superannuation Fund, she could commute her own pension back to Accumulation Mode which at the time of Mr Smith's death was $1.8 million.

This would provide her with room in her own Transfer Balance Cap to then accept Mr Smith's pension of $1.8 million. This keeps Mr Smith's complying pension within the Fund but transfers Mrs Smith's complying pension back into Accumulation mode.

Mrs Smith would still need to pay out Mr Smith's Accumulation Fund outside the Superannuation System.

Diagrammatically this would look as follows:

Action Post Death of Mr Smith



Issues for you to consider

As part of this review process, you need to reconsider what proportion of your accrued superannuation entitlements you want your spouse to access on your death. If this is not 100% of the accrued superannuation entitlements, you need to identify to whom you want these assets to go to and what structure should hold these assets.

Secondly, where accrued superannuation entitlements need to be withdrawn on death, what will be the structure to hold these assets so withdrawn from the Superannuation System?

Action required!

As you can see there are many issues to consider in preparing for the changes effective 1 July 2017.

A lot of work needs to be done to accumulate your current factual position so we can marry up your factual circumstances with your intentions and come up with the optimal strategy, not only from an income tax perspective but also from an asset succession perspective.

I look forward to working through these issues with you in the New Year in methodical fashion, taking into account your intentions and specific financial situations.

If you have any queries in relation to any information disclosed above, please do not hesitate to contact me.

As you would appreciate, the information is general in nature and needs to be applied to your specific fact circumstance.

Regards

Anthony Jackson