PART 1- SUPER CONTRIBUTION CHANGES

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As part of the 2016 Federal Budget and subsequent announcements, the Government is making significant changes to super contribution rules.

On Wednesday 23 November 2016, the Federal Government's proposed changes to super rules passed through Parliament[1]. It's worth understanding how the new rules will affect you and your financial strategy.

What's changing from 1st July 2017?

Current rule	New rule (from 1 July 2017)
Concessional (pre-tax) contributions	
Age at start of the financial year: Under 49: $30,000 pa 49 or more: $35,000 pa	**$25,000 pa, regardless of age**
Contributions are taxed at up to 15%. Higher income earners have their contributions taxed at 30% if their taxable income is over $300,000	**30% tax on contributions for higher income earners starts once you earn $250,000.**
A tax deduction on contributions made can be claimed for those who have less than 10% of their income from employment – essentially sole traders, retirees or unemployed people.	**Everyone will have the ability to claim a tax deduction for personal contributions to super.**
Non-concessional (after-tax) contributions	
$180,000 annual contributions cap	**$100,000 annual contributions cap. No further non-concessional contributions permitted if your total super balance at the start of the financial year is $1.6 million or more.**
'Bring forward' rule allows three years' worth of contributions (i.e. $540,000) to be made any time during a three-year period if under 65 (any time during the year).	**'Bring forward' rule allows a maximum of $300,000 to be made any time during a three-year period if under 65 (any time during the financial year).**

[1] While the changes have passed both houses of Parliament, they will become formally legislated upon receiving Royal Assent.

What is a concessional contribution? – Refresher

Pre-tax or concessional super contributions are the contributions you make without paying your marginal rate of income tax on them. They include:

- Compulsory contributions from your employer, such as Super Guarantee (SG) contributions;
- Voluntary employer contributions such as salary sacrifice contributions that you choose to make from your before-tax income;
- Personal tax-deductible contributions – for example, the ones you make if you're self-employed (note that from 1 July, everyone will be able to make personal tax-deductible super contributions).

These contributions are usually taxed at the low rate of 15% unless the individual is a high-income earner (as discussed in the table above).

Changes to the Caps

Currently, you can make up to $30,000 in concessional contributions in a financial year if you were under age 49 at 30 June 2016 or $35,000 if you were older.

This will be changed to an annual cap of $25,000 for everyone from 1 July 2017.

Carry forward Concessional Contributions

Individuals with super interests of less than $500,000 on 30 June of the prior financial year will be able to make concessional contributions above the $25,000 annual cap, where they have not fully utilised their cap in previous financial years.

Unused amounts will be able to be carried forward on a five-year rolling basis. The new regime will only apply to unused amounts accrued from 1 July ***2018***.

This means that the 2019/20 financial year will be the first year that a person could potentially 'make use' of an unused carried forward concessional contributions if the eligibility criteria are met. However, this benefit will only arise where a person has sufficient taxable income in future years to utilise the strategy.

Personal deductible contributions

Currently a person who is in an employment arrangement may not be able to optimise their concessional contributions. Examples include where:

- An employer is unwilling to facilitate a salary sacrifice arrangement.
- Employment income is not sufficient, even if fully sacrificed, to reach the desired level of contributions because there is income from other sources, and
- Personal income is uncertain, for example bonuses, and is received late in the tax year such that it is not possible to salary sacrifice a sufficient amount.

From 1 July 2017 individuals will be able to claim a tax deduction for personal contributions regardless of the amount of income received from employment.

Important changes to non-concessional contributions:

Also known as after-tax contributions, these are contributions you make from sources that have already been taxed. They generally include:

- Contributions from your take-home pay or savings, where no tax deduction has been claimed
- Certain contributions made by your spouse on your behalf.

Currently these are capped at $180,000 a year. Or, if you're under the age of 65 (at any time during the financial year), you are able to apply the 'bring-forward' rule. This allows you to make up to three years' worth of non-concessional contributions (currently $540,000) at any point during a three-year period.

The Government has reduced the annual cap to $100,000 from 1 July 2017.

Under the new rules, if you're eligible you'll still be able to apply the bring-forward rule and contribute up to $300,000 at any time during a three-year period. Where the bring-forward rule has been triggered before 1 July 2017, transitional rules may apply.

In addition, from 1 July 2017 the Government will no longer allow you to make any further non-concessional contributions, once your total super balance reaches $1.6 million.

Who can contribute to super?

No changes have been made regarding who can contribute to super. As a recap, generally anyone under the age of 65 can make concessional or non-concessional contributions to their super.

If you're aged 65 to 74 you have to pass a work test before you can contribute. This means you need to have worked (for gain or reward) for at least 40 hours within a 30-day period to be able to contribute for that financial year.

If you're 75 or over, you're usually not able to make voluntary contributions to super.
These eligibility rules don't apply to your employer's compulsory contributions (i.e. the SG contributions). They can be made at any time, regardless of your age.

What happens if you go over the caps?

These penalties apply if you exceed the super contributions caps:

- **Concessional contributions:** The amount of your excess contributions are included in your assessable income and effectively taxed at your marginal tax rate. You'll also have to pay an interest charge. You can also choose to withdraw up to 85% of any excess concessional contributions, although if you choose not to withdraw them, the excess amount will also count towards your non-concessional contributions cap.
- **Non-concessional contributions:** You can choose to withdraw the excess amount and 85% of an 'associated earnings amount', which is what your excess contributions are deemed to earn while in your super account. The total amount of associated earnings will be included in your assessable income and taxed at your marginal rate, with a 15% offset. Otherwise, if you don't withdraw the excess amount, it will be taxed at 49%.

Part 2 – TTR PENSIONS

What's changing from 1st July 2017?

Income generated from assets supporting transition to retirement (TTR) pensions will be taxed as ordinary income (max. rate of 15%) of a superannuation fund from 1 July 2017, rather than being previously tax free, therefore the benefit from a TTR strategy will be limited.

The changes that may reduce or limit the pay-off from a TTR strategy are the:

- Removal of the tax exemption for fund earnings in pension phase when the pension is by definition, a 'Transition to Retirement Income Stream' and
- Reduction in the concession contributions (CC) cap to $25,000 for all taxpayers from 1 July 2017, which will limit additional salary sacrifice and personal deductible contributions that can be made to maximise the personal income tax benefits available from the strategy.

The payoff from the TTR strategy may be improved by the:

- Introduction of the 'catch up' CC regime from 1 July 2018, and
- Broadening of the ability to claim tax deductions for personal contributions to include those who have more than 10% of their income from employment activities.

When does a TTR become an Account Based Pension?

A TTR pension is not classified as being in 'retirement phase'. However, once a person retires or meets a full condition of release, the TTR becomes an account based pension, and will receive tax exemption status.

A condition of release is met upon:

- Turning age 65;
- Taking on temporary work that ceases after turning 60;
- Reaching preservation age (age 60) and ceasing gainful employment (declaring you have no intention of working more than 10 hours per week in the future).

Further, if a condition of release was met prior to starting the TTR pension, and it is made up entirely of unrestricted non-preserved super, then it is considered to be an account based pension.

When might a TTR pension be appropriate?

1. Individuals reducing working hours

The ability to start a TTR pension after reaching preservation age was originally introduced to enable individuals to 'transition to retirement' in the true sense of the phrase; that is, to reduce their working hours, while being able to access some of their super to supplement their income.

TTR pensions may still be appropriate for these individuals, regardless of these new changes. While the net tax benefit will reduce the tax 'payoff' from the strategy, for many, their lifestyle objectives will be their priority, and potentially the key motivation to accessing their super as a TTR pension.

2. Individuals <60 with a large tax free-component

The tax components of a pension are fixed at the commencement of the pension. Individuals, who have commenced a TTR pension with a relatively large tax free component, won't escape having to pay fund internal tax on account earnings, but the effectiveness of a TTR strategy for these individuals might be preserved to an extent, due to a reduced personal tax liability on income payments.

Let's say an individual has a super balance that is 50% tax free and 50% taxable. If a TTR is commenced, the pension payments will also be 50% tax free, and the 50% that is taxable will receive a 15% tax offset.

3. Those wanting to implement a re-contribution strategy

Commencing a TTR may be a way to access super before retirement so that the pension income received can be contributed back into super.

This may allow an individual to increase the tax-free portion of their super balance, or manage the $1.6m pension transfer cap by evening up super balances between couples.

Part 3 –SUPER WITH BALANCE GREATER THAN $1.6 MILLION

What's new?

The Government has introduced legislation supporting the $1.6 million transfer balance cap which will limit the amount that can be held in the pension phase of super.

The limit applies per person and it's possible for up to $3.2 million to be transferred to pensions by a couple.

Transfer balance cap

The transfer balance cap applies to 'retirement phase recipients'. This is a new concept that describes a person who has commenced a superannuation income stream.

A person will be a retirement phase recipient if either:

- A superannuation income stream is payable to them, or
- a deferred income stream is payable to them after a determined time and they have met the retirement, terminal medical condition, permanent incapacity or attaining age 65 condition of release.

A transition to retirement (TTR) income stream is specifically **excluded** from being in 'retirement phase'.

Individuals will have a transfer balance account at the later of:

- 1 July 2017, and
- When a superannuation income stream is first commenced.

It’s important to understand when you first have a transfer balance account, as this will determine the:

- Transfer balance cap amount that will apply, and
- Proportional indexation in future years (if applicable).

Transfer balance accounts will be maintained by the ATO, where credits and debits will be applied. The transfer balance account ends when the person of the relevant transfer balance account dies.

Credits

The transfer balance account will have credits made when an income stream commences from 1 July 2017 or if a retirement phase income stream exists at 30 June 2017. These amounts are called ‘transfer balance credits’.

Example 1:
Danny, age 58, retires and commences an account based pension on 15 August 2017 with $1 million. He has no other superannuation income streams. Danny’s transfer balance cap is the cap applicable for 2017/18 of $1.6 million.

Example 2:
Justin, age 65, retired in 2014/15 and started an account based pension at that time with $750,000. He has no other income streams. The account balance of Justin’s account based pension as at 30 June 2017 is $745,000. This valuation is credited against his transfer cap of $1.6 million.

Example 3:
Leslie, age 62, retires in 2020/21 and starts her account based pension on 18 September 2020 with $800,000. She has not previously commenced a superannuation income stream. Leslie’s transfer balance cap is the cap applicable for 2020/21 of $1.7 million (assuming indexation).

Debits

The transfer account balance will have amounts debited, such as when a commutation is made from the income stream.

A debit will reduce the amount assessed against an individual’s transfer cap balance. This ensures that amounts are not double counted, such as when the amount is rolled over to commence a new income stream with another provider. **Note:** It is possible for a transfer balance account to be negative. A debit will be added to an individual’s transfer balance account if:

- A commutation is made to a lump sum and received in cash;
- A commutation is made and the amount is rolled over to commence a new superannuation income stream;
- A commutation is made and an amount is returned to the accumulation phase;
- A contribution is made to superannuation under a structured settlement e.g. divorce;
- Certain events arise, such as fraud, dishonesty or bankruptcy;
- Payments are split under family law;
- An excess amount is transferred under a notice issued by the Commissioner.

Indexation

The general transfer cap in 2017/18 is $1.6 million. This cap will be indexed in future years to CPI in $100,000 increments (rounded down).

Those who have not triggered a credit against their transfer cap balance will benefit from the full increase of any indexation. Those who have utilised their full cap will NOT benefit from any future indexation.

Those who have commenced income streams but have not utilised the full cap will benefit from indexation but only on a proportional basis. Indexation will apply only to the unused proportion of the transfer cap balance:

Unused cap % x indexation increase

The unused cap percentage is determined by identifying a person’s highest balance in the transfer balance account and their transfer balance cap. It is rounded down to the nearest whole number.

Excess transfer balance

An excess transfer balance occurs if your transfer balance account exceeds your personal cap. This will give rise to excess transfer balance tax.

Those who have an excess will need to:

- Reduce the amount held in pension phase (e.g. via a partial commutation), and
- Pay excess transfer balance tax.

The excess transfer balance tax is to remove any benefit derived by having an excess amount held in the pension phase with earnings taxed at 0%.

Excess transfer balance tax

Excess transfer balance tax is payable for all days where an amount is held in the pension phase in excess of the cap. It is a tax on the individual.

The ATO will calculate an amount of 'notional earnings', which is calculated using the general interest charge (around 9.2% pa) compounded daily from the date the excess occurred.

15% tax will be payable on the notional earnings. For second and subsequent breaches, this tax rate increases to 30%.

Example 5

Leslie commences an account based pension with $2 million on 18 August 2017. This exceeds her $1.6 million transfer cap by $400,000. After 30 days, she realises her mistake and decides to **roll back** an amount to accumulation mode. The amount that must be rolled back is the excess amount of $400,000, plus notional earnings of $3,036.

The amount of $403,036 is debited against Leslie's transfer balance account, bringing it back to $1.6 million. As Leslie has reached her cap, she cannot have any further amounts added to the pension phase. The notional earnings of $3,036 will be taxed at 15%.

Define Benefit Pensions

Special rules apply for defined benefits, term annuities and pensions, and lifetime pensions in managing the $1.6m pension transfer cap. In general, lifetime pensions will be valued at 16 times the annual income being paid. As these types of pensions cannot be rolled back to super, if an excess occurs they have to roll back other pensions to the extent they can, and pay additional taxes on the defined benefit pension payments if an excess remains.

CGT relief

The legislation allows CGT relief to assets that are moved out of pension phase to satisfy the requirements of the transfer cap balance.

The purpose is to provide tax relief for superannuation funds from capital gains accumulated before 1 July 2017, where the gains would have been exempt if released prior to making changes to meet the transfer cap balance requirements.

The CGT concessions only apply to the transfer of assets to comply with the new legislation. The concession applies to both account based pensions and transition to retirement income streams.

IS IT TIME TO REVIEW YOUR SUPERANNUATION STRATEGY?

Whilst these changes don't start until 1st July 2017, the time to start thinking about these issues is now. These changes are going to affect many of our clients and we will work with you to determine how best to utilise the rules going forward. We flag the following issues as points to discuss with us:

- If you have a SMSF with one or more pensions in place, do not make ANY contributions into the fund without first seeking advice. Doing so may compromise the CGT relief available to you if you have to roll any balances back to accumulation phase.
- If you have access to personal savings and are eligible to contribute them to super, the higher $540,000 limit applies up to 30 June 2017, if you have not previously triggered the bring forward rule. Going forward the rules will not allow such generous contributions to be made.
- If you have previously commenced a TTR pension, it may be the case that a full condition of release has subsequently been met and the fund has not been advised.

Therefore, there may be an opportunity to discuss with us whether a full condition of release has been met, so that your pension can continue its tax-exempt status.

- If you have close to or more than $1.6m in super and/or pensions, then you may need to implement strategies to manage the pension transfer cap. Options include:
  - Retaining funds in accumulation phase;
  - Making a partial lump sum withdrawal;
  - Spouse contributions & splitting contributions with a spouse;
  - Starting a TTR and re-contributing the pension income to a spouse.
- Review appropriateness of TTR pensions and consider whether they should be rolled back to accumulation phase.
- If you need to roll TTR or other pension money back into accumulation phase, are you aware of the potential for CGT relief on your super investments if you take action before 1st July 2017?
- If you have a partner who is nominated as the beneficiary under an automatic reversion, then this should be reviewed if your combined balances are close to or over $1.6m.
- If you have a SMSF, have you considered the various issues that arise, such as liquidity requirements and asset segregation issues?
- For SMSF's, trust deeds may need to be updated in light of the legislative changes.
- Special rules apply for defined benefits, term annuities and pensions, and lifetime pensions in managing the $1.6m pension transfer cap. Clients with any of these types of income streams as well as other super should contact us for further advice.

Looking for Financial Advice?

In an ever increasingly complex financial and legislative world, our mission is to provide you with clear, concise and tailored strategic advice.

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