$1.6m super transfer balance cap

by Ben Miller, Senior Writer, Wolters Kluwer CCH

Abstract: With the announcement of the federal Budget on 2 May 2016, superannuation laws regarding pensions were tipped to change. After the ensuing re-election of the Coalition, it can be easy to forget that we have had almost a year to get used to the idea of the transfer balance cap. The questions surrounding this new legislation have been varied and expansive. What specifically is the new law, and what are the opportunities for clients and practitioners? What are the issues when a member has more than $1.6m? What are the options when there is more than one member in the fund? How should we deal with succession or estate planning? The ability to articulate tax changes to your clients, with examples and practical guidance, is invaluable for any major new law coming into effect.

The new law

The transfer balance cap is a lifetime limit of superannuation an individual can transfer into a tax-free pension account. The $1.6m cap will apply from 1 July 2017, and will include:

- the value of superannuation interests supporting an income stream on 30 June 2017;
- the commencement of a new income stream after 1 July 2017; and
- the value of any reversionary income streams.

A member of a superannuation fund will begin to have a transfer balance account on the later of 1 July 2017 and the first day the member becomes a retirement phase recipient of a superannuation income stream.

The term "retirement phase" is determined to be when the member meets a full condition of release and hence the superannuation benefit becomes unrestricted non-preserved. A superannuation income stream is in the retirement phase when the income stream is currently payable. Effectively, the income stream is payable when the member elects to commence an income stream.

Any amount in excess of the $1.6m cap will also accrue a notional amount of earnings that will be credited against the cap, and no further non-concessional contributions will be allowed.

Importantly, only the amounts listed above are "credited" against the $1.6m cap. Any earnings or income stream payments after 1 July 2017 on pension accounts will not add or reduce the total. Balances above $1.6m in pension phase could be reduced ("debited") to the transfer balance cap by a full or partial commutation. The amounts could either be transferred back into accumulation phase or paid as a lump sum.

The legislation also stipulates that any lump sum payments from 1 July 2017 will not count towards the prescribed minimum pension standards.

The transfer balance cap will be most important to members who are near or are over $1.6m in superannuation. In these situations, the member will want to know exactly what is the maximum amount that can go into retirement phase and how it can best be utilised. In most cases, the important thing to remember is to endeavor to avoid an excess transfer balance, hence avoiding the associated tax that goes with it.

Example: calculation of transfer balance cap and tax

Daniel is 67 years of age and, as at 30 June 2017, he has a superannuation balance in his self-managed superannuation fund (SMSF) of $1,115,000 in a pension account and $85,000 in an accumulation account. He has no other balances in superannuation.

On 1 July 2017, he requests the trustee to revert his entire pension account back into accumulation phase and then immediately commence a new account-based pension for the entire balance of $1,200,000. This balance has a mixture of taxable and tax-free member components for Daniel.

A contract for the sale of Daniel's business is signed on 15 February 2018, with settlement to be six months later on 15 August 2018. Daniel is set to make a capital gain on the transaction of $1,848,000, which will be reduced by 50% on the capital gains tax (CGT) general discount and a further 50% active asset test exemption available for small businesses.

On 15 August 2018, Daniel receives the proceeds from sale and elects to use the retirement exemption to disregard the remaining capital gain of $462,000. He is able to contribute the gain into the SMSF as he is under the lifetime cap of $500,000. Daniel is also able to make the contribution as he has passed the work test, and advises the trustee of this fact.

Immediately after depositing the gain, he commences a new account-based pension for the entire $462,000 deposit. This pension will have a 100% tax-free member component.

The calculation of Daniel's personal transfer balance amounts is as follows:

Account	Commencement	Amount
Pension 1	1 July 2017	$1,200,000
Pension 2	15 August 2018	$462,000
Total		$1,662,000
Transfer balance cap		$1,600,000
Amount cap exceeded		$62,000

By commencing the new pension, Daniel has exceeded the transfer balance cap of $1.6m by $62,000.

On 31 August 2018, the Commissioner of Taxation issues an excess transfer balance determination as follows:

Excess transfer balance	$62,000
Days exceeded	16
Accrued notional earnings rate	9.2%
Notional earnings	$250
Crystallised reduction amount	$62,250

Following the Commissioner's determination, on 3 September 2018, Daniel transfers an amount of $62,250 out of pension account number 1 as a superannuation lump sum payment, reducing the transfer balance cap under the allowable limit.

The Commissioner then assesses Daniel for excess balance tax as follows:

Notional earnings	$250
Tax (at 15%)	**$37.50**

The excess balance tax is a tax that is intended to neutralise the advantage that Daniel receives from the superannuation funds' earnings tax exemption while in pension phase.

The superannuation lump sum payment cannot count as a pension payment when calculating the prescribed minimum pension to take from pension account number 1 for the 2018-19 income year.

An important thing to note about this example is that the excess balance tax assessment may be alleviated if Daniel was to make a lump sum withdrawal from pension account number 1 prior to the second pension commencing. However, in order to make a lump sum payment from a superannuation balance, the account balance must be calculated before the payment is made. This means a set of interim accounts would be necessary to make the lump sum on 14 August.

As a rule of thumb, an amount of $100,000 would accrue $25 per day it is included in the transfer balance amount.

Tip: From 1 July 2017, a new report will be available which informs the regulator that a pension has begun. This will include when a benefit will change from transition to retirement to an account-based pension.

Other new legislation would prohibit a non-concessional contribution should the balance be at or above $1.6m. After taking into consideration cash flow circumstances, Daniel may be able to make a non-concessional contribution up to his limit prior to making the CGT retirement contribution. The small business concession contributions do not count towards the non-concessional cap.

Reversionary pensions

There are two types of reversionary pensions and their treatment is different for the purposes of the transfer balance cap.

For an automatic reversion, the value of the income stream counted against the transfer balance cap is the account balance on the date of death of the original spouse. A grace period of twelve months will be allowed to get account balances under the transfer balance cap after the death.

The term "automatic" means that the entitlement to receive the superannuation income stream passes immediately on the member's death to the beneficiary. The superannuation income stream reverts in this manner because the rules of the fund or the agreement/standards under which the superannuation income stream is provided expressly provide for the reversion, as opposed to the superannuation provider exercising a power or discretion to determine an amount in the beneficiary's favour.
A binding death benefit nomination, by itself, does not make a superannuation income stream reversionary.

For the beneficiary of a non-automatic reversionary death benefit, a transfer balance credit arises when the income stream commences on their behalf by the trustee of the fund. These amounts may include any investment earnings that accrued to the deceased member before commencement of the income stream, as well as other amounts that may be added to a member's balance post-death, such as an amount paid under a life insurance policy. A common situation in SMSFs may be that the members do not have a death benefit nomination so that the surviving trustees are not bound by a decision which may later be unfavourable. Also, the *Superannuation Industry (Supervision) Act 1993* (Cth) states that the surviving trustees must make a decision as soon as practicable after the death of the original member. There is no specific timeframe to make a reversionary decision, however it must still satisfy the regulator that it was "as soon as practicable".

In both instances, there is a credit to a member's transfer balance cap if a reversionary pension is already underway as at 1 July 2017. In this circumstance, the credit to the cap is the value of the entire benefit at 1 July 2017, not just the amount that was reverted. Similarly, there is a 12-month grace period should the reversionary pension straddle the 30 June 2017 law change. For example, if a member passes away on 1 January 2017, the automatic credit to the reversionary pensioner will occur on 1 January 2018.

In summary, Table 1 shows the slight variations based on the type of reversionary pension allowed and when it commences.

Table 1

Date of death	Automatic reversionary pension	Non-automatic reversionary pension
Before 30 June 2017	Credit to the transfer balance cap is the super balance at 30 June 2017. Surviving member has 12 months from reversion to rectify an excess if reversionary began after 1 July 2016.	Credit to the transfer balance cap is the later of 1 July 2017 and the date the reversionary income stream is granted.
After 1 July 2017	Credit to the transfer balance cap is the super balance at the date of death. Surviving member has 12 months from date of death to rectify any excess.	Credit to the transfer balance cap is the balance of the account when the reversionary income stream is granted.

Example: how the reversionary pension balances will look

John has a reversionary pension worth $1.1m at the time of his death on 1 August 2017. The pension reverts to John's wife, Heather, automatically. Heather already has her own pension and a transfer balance account with a balance of $1m.

Heather is a director of the trustee company and is advised that, unless she acts, the combined value of the two pensions will cause her to breach her transfer balance cap. Heather has a number of options to respond to the situation. She can fully commute either pension or she can undertake a partial commutation for the amount of the potential excess, $500,000.

On 1 December 2017, Heather makes a partial commutation of her pension and moves $500,000 back into accumulation phase. On that date, a debit arises in her transfer balance for that amount bringing her transfer balance account down to $500,000. The $1.1m credit in respect of the reversionary pension arises in Heather's transfer balance account on 1 August 2018. Heather will not breach her transfer balance cap.

For the 2017-18 income year, the SMSF has taxable income of $116,000 with no capital gains.

During the year, Heather withdraws a total of $66,000 from John's reversionary pension and $55,000 from her pension account, meeting the minimum draw-down requirements.

At the beginning of the year, superannuation interests that funded income streams totalled $2.095m. The calculation of the member's account share of the fund for the 2017-18 income year is as follows:

	John (now reversionary)	Heather pension	Heather accumulation	Fund
Opening balance	1,095,000	1,000,000	–	2,095,000
Transfer	–	(500,000)	500,000	–
Pensions	(66,000)	(55,000)	–	(121,000)
Closing balance	1,029,000	445,000	500,000	1,974,000
Average balance	1,062,000	722,500	250,000	2,034,500
Average balance %	52.20%	35.51%	12.29%	–
Income	60,552	41,192	14,256	116,000

At the end of the year, an actuary calculates that the current exempt pension percentage of the fund is 87.71%.

The taxable income of the fund is $14,256, with tax payable at 15% totalling $2,138.40.

As the transfer between pension account and accumulation account occurred after 1 July 2017, there would be no CGT relief for assets that were in full pension phase at 30 June 2017 (as no transfer balance cap was breached).

Tip: Most reversionary pensions are binding and would not allow a partial lump sum to occur. In these situations, the trustee of the fund may be bound by the direction of the nomination, as opposed to having discretion on how to handle the affairs of the fund once a member dies. In the above example, no consideration is given to members' taxable components.

CGT relief

Transitional CGT relief will apply where the assets of the fund are required to be moved from pension phase (where CGT is disregarded) to accumulation phase. A superannuation fund trustee could choose to reset the cost base of an asset on 1 July 2017 so that any unintended taxes are mitigated.

The CGT relief may apply for funds that have unsegregated assets and use the proportional method (ie an actuarial certificate) for the 2016-17 year. In the situation where a fund may have a CGT liability due to a resetting cost base, it could be deferred for 10 years.

Example 1: applying CGT relief in full pension phase

Belinda is 67 years of age and the sole member of the Beachview Superannuation Fund, which is a complying SMSF. As at 1 July 2016, the fund is in full pension phase, and therefore is a fully segregated fund.

The accounts for the 2015-16 income year were prepared, with the assets of the fund as follows:

Asset	Cost base	Market value
Non-commercial property	$850,000	$1,050,000
Shares in listed companies	$650,000	$650,000
Cash and equivalents	–	$200,000
Total value of assets/member's balance	–	$1,900,000

By 1 July 2017, Belinda is required to reduce her pension account to $1.6m in accordance with the legislation. As sole director of the trustee company, she draws up the following resolution:

> "As at 30 June 2017, the fund is to revert all of my pension account back into accumulation phase, and commence a new pension for $1.6m."

The fund is now an unsegregated fund and Belinda chooses to reset the cost base for the property and the shares at 30 June 2017. The fund is in 100% pension phase for the 2016-17 income year, meaning any capital gains will be disregarded in the annual return.

After year-end, Belinda completes the accounts. On 30 June 2017, the assets are:

Asset	Cost base	Market value
Non-commercial property	$1,200,000	$1,200,000
Shares in listed companies	$700,000	$700,000
Cash and equivalents	–	$100,000
Total value of assets	–	$2,000,000
Belinda's member balance		
Pension		$1,600,000
Accumulation		$400,000
Total member balance		$2,000,000

In the 2019-20 year, Belinda sells the non-commercial property for $1,400,000. The capital gain is included in that year's annual return, which is as follows:

Proceeds	$1,400,000
Less:	
Cost base (reset at 30 June 2017)	$1,200,000
Costs of sale	$20,000
Total cost base	$1,220,000
Gross capital gain	$180,000
1/3 discount applies	($60,000)
Net capital gain	$120,000
Less: ECPI (70%)	($84,000)
Taxable gain	$36,000
Tax (15%)	$5,400

The example has assumed that the exempt current pension income will reduce over time from 80% as at 1 July 2017 due to pension payments. The 70% represents an actuarial percentage.

Example 2: two members, already using proportionate method

In this example, the Beachview Superannuation Fund has a second member, Deidre, who is 58 years of age, with a balance in accumulation phase of $1m.

The assets of the fund at 30 June 2017 are as follows:

Asset	Original cost	Reset cost base	Market value
Non-commercial property	$850,000	$1,200,000	$1,200,000
Shares in listed companies	$1,300,000	$1,500,000	$1,500,000
Cash and equivalents	–	–	$300,000
Total value of assets			$3,000,000
Belinda – pension			$1,600,000
Belinda – accumulation			$400,000
Deidre – accumulation			$1,000,000
Total member balance			$3,000,000

Assuming that the exempt current pension income (ECPI) percentage is 67% for the 2016/17 income year, a capital gain occurs for the assets of the fund where CGT relief has been applied. The fund is required to calculate the assessable income for the assets *as if they were sold in the 2016-17 year.*

The capital gain for the non-commercial property is $350,000. Assuming that the general discount (1/3) would apply, the assessable income for the year would have been ($350,000 × 2/3 × 33%) $77,000. Using the same method, the shares would have an assessable income of $44,000.

The $121,000 in assessable income is allowed to be deferred until the asset is actually sold, for a maximum of 10 years.

As per the above example, in the 2019-20 year, the fund sells the non-commercial property for $1.4m. The calculation of the capital gain is as follows:

Proceeds	$1,400,000
Less:	
Cost base (reset at 30 June 2017)	$1,200,000
Costs of sale	$20,000
Total cost base	$1,220,000
Gross capital gain	$180,000
Deferred assessable income	$77,000
Total capital gain	$257,000
1/3 discount applies	($86,000)
Net capital gain	$171,000

The tax payable in this example is dependent on what the exempt current pension percentage is for the 2019-20 tax year. The exempt percentage can change from year to year and is based on the actions of the members in that particular year.

For the above example, if Deidre had retired by meeting preservation age and no longer intending to be gainfully employed, the exempt percentage could be drastically different.

In the example, if Deidre was still in accumulation phase, the ECPI% would be 50%, making a taxable gain of $85,500 and tax payable of $12,825 on sale of the property.

If Deidre had retired and commenced an income stream, the ECPI% would be 85% and tax payable would be $3,847.50.

The CGT relief will be incorporated into the CGT schedule of the SMSF annual return through new data fields in the 2016-17 income year.

Conclusion

As with any new superannuation regulation, several factors come into play in order for a trustee to decide the best outcome going forward in their circumstances.

An option may be to remove the portion of the balance of a superannuation account into the hands of the individual member. This may have a beneficial outcome due to the individual marginal tax rates and the associated low income tax offset and seniors and pensioners tax offset benefits. However, amounts that are removed from the superannuation regime will no longer have the benefit of asset protection from creditors. Also, for estate planning purposes, the superannuation account is dealt with outside of an individual's will.

For account-based pensions that have been in operation for a long period of time, it may be beneficial to keep the existing pension and commute a certain amount out (either of superannuation completely or to accumulation phase) in order to get back to $1.6m.

As the new law relates to a member's pension, the first point of review should be around matching the required living expenses to the cash flow requirements of the fund, and start from there.

The above also suggests that for funds that are currently in 100% pension phase, moving back to an unsegregated method could create benefits with CGT relief on superannuation assets. However, CGT relief is not necessarily a "tick the box" decision. Many factors should be considered before making the decision as it is irrevocable. Trustees have until the lodgment of the annual return for the 2016-17 income year to make decisions regarding individual SMSF assets.

Most importantly, keeping timely up-to-date records of your SMSF member's account balances will be imperative going forward and may provide you with opportunities to monitor them now and throughout the ensuing years. It is advised that practitioners review all their clients' superannuation balances, whether or not they have an SMSF.

Make sure you ask your clients questions. Do they have any balances sitting in a retail fund? Did they ever work for the government? Have they checked recently? Only when you have the complete understanding of the overall affairs of your client's superannuation situation can you best advise them of the traps and opportunities.

Ben Miller
Senior Writer
Wolters Kluwer CCH

Corrigendum

This article referred to capital gains tax relief for superannuation funds where member balances needed to be moved from pension phase back to accumulation phase. When the draft Treasury Laws Amendment (Fair and Sustainable Superannuation) Bill 2016 (draft Bill) was originally tabled to parliament, the draft explanatory memorandum (draft EM) that accompanied the draft Bill referred to a limit in which the superannuation fund could, in fact, defer these gains (refer to para 1.24 in the draft EM).

In particular, under the draft Bill, an SMSF using the proportionate method prior to 30 June 2017 could defer capital gains for a maximum of 10 years under transitional rules. The draft Bill was subsequently amended and the 10-year period was omitted from the draft Bill. As a result, the deferral of capital gains that would apply due to the operation of the transfer balance cap will exist until such time as the asset is sold.

Also, in the worked example in the article, the $121,000 in assessable income can be deferred until the asset is actually sold.