Heffron SuperNews

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Heffron SMSF Solutions

Problem solved

The Government has introduced a $1.6m pension transfer balance cap from 1 July 2017. This edition of SuperNews explores the mechanics of this cap in greater detail.

Introduction

The purpose of the pension transfer balance cap (the 'cap') is to limit the extent to which an individual can generate *tax exempt investment income* within the superannuation environment.

The legislation [1]:

- prescribes the actual **personal transfer balance cap** that will apply to an individual that commences a 'pension';
- sets a **general transfer balance cap** of $1.6m for 2017/18, and indexes this general cap in future years in line with movements in the CPI in increments of $100,000;
- prescribes the amounts that will be 'credited to' that individual's cap (ie, **count towards**, or use up, the cap), and what amounts will be 'debited from' it (ie, **reversed from, or no longer use up**, the cap);
- prescribes how much (if any) **indexation** will apply to the individual's personal transfer balance cap; and
- prescribes the treatment of amounts in excess of an individual's personal transfer balance cap.

What is a 'pension' for the purposes of the 'cap'?

For the purposes of the cap, a pension is any income stream that is comprised *solely* of unpreserved money. Generally, this means that the member has satisfied the criteria to have full access to their underlying account balance upon the earliest of:

- reaching age 65;
- retiring [2];
- becoming permanently incapacitated;
- suffering from a terminal illness or injury (where death is likely within no more than 2 years); or
- death.

Importantly, a transition to retirement income stream (TRIS) is *not* a pension for the purposes of the cap whilst it remains a TRIS. This makes sense in the context of the broader Government proposals as income generated from assets that underpin TRIS balances will *no longer be exempt from tax* (and will instead be taxable) from 1 July 2017 in any case.

For the remainder of this Super News, whenever we say 'pension', we mean a pension comprised *solely* of unpreserved money and are ***specifically excluding transition to retirement income streams***.

Personal transfer balance cap

Every individual will have a personal transfer balance cap ('personal cap'), and their personal cap will be *activated* the first time one of the following events occurs:

- 1 July 2017 for anyone who has a pre-existing pension on that date;
- the date an individual's first ever pension commences after 1 July 2017 ;
- the date a TRIS becomes an account-based pension (ie, at the time the individual gains full access their superannuation, as outlined earlier); or
- in the case of a pension that reverts to the individual because of someone else's death, 12 months after the date of deceased's death.

The *amount* of an individual's personal cap will be determined when it is first activated, and the amount will correspond to the **general transfer balance cap** that applies for that financial year, and it will be **locked in for the life of the individual.** (Subsequent indexation of this amount is discussed below).

General transfer balance cap

The 'general cap' is simply a fixed dollar amount initially set at $1.6m for 2017/18.

The fixed dollar amount of $1.6m will be subject to annual indexation (in line with CPI), in increments of $100,000 (rounded down) (via new section 960-290 of the ITAA 1997).

Consider the following example.

Adam first commences an account-based pension in 2021/22. By that time, the *general cap* has been indexed to $1.7m. As this would be the first ever pension Adam has had, the act of

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[1] Via new Division 294 of the ITAA 1997

[2] Retirement has a specific meaning in the context of superannuation.

In the case of an individual that has reached preservation age that is **less than 60**:

- a paid employment arrangement has ceased (either now or in the past); and
- the trustee is reasonably satisfied the member never intends to be gainfully employed (for 10 or more hours per week) in the future.

If the individual is aged **60 or over:**

- a paid employment arrangement ceases after age 60; or
- an arrangement under which the member was gainfully employed has come to an end (either now or in the past) and the trustee is reasonably satisfied the member never intends to be gainfully employed (for 10 or more hours per week) in the future.

commencing the pension causes Adam to activate his personal cap and *lock in* a lifetime personal cap of $1.7m. Even if Adam commutes this pension in the future (in full or in part), his personal cap will remain at $1.7m – this is because **it is locked in for life when it is activated,** and it was activated by starting a pension.

Proportional indexation of an individual's personal cap

In cases where an individual **fully utilises their personal cap** at any point in time, **no indexation will ever apply to their personal cap** in future years – even if the general cap is indexed, and even if the individual commutes their pension(s) in the future (in full or in part) so that they have some 'space' available within their lifetime cap. Treasury have indicated that this is a deliberate integrity measure.

In contrast, *some* indexation will apply in cases where an individual has an amount assessed against their personal cap, but does *not* fully utilise it.

In these cases, the *unused portion* of their personal cap (known as 'unused cap percentage') will be indexed in line with increases in the underlying general cap.

Consider the following example.

The value of Belinda's pre-existing account-based pension on 30 June 2017 was $900,000. As a result, this amount will be assessed against her personal cap on 1 July 2017.

Belinda's unused cap percentage is calculated by:

- expressing $900,000 as a percentage of her personal cap (rounded down to the nearest whole percentage), ie:

$$\frac{\$900{,}000}{\$1{,}600{,}000} = 56\%$$

- subtracting the result (ie, 56%) from 100%.

In other words, Belinda's unused cap percentage is 44%.

When the underlying general cap is indexed in the future by $100,000 to $1.7m, Belinda's personal cap would be proportionately indexed by $44,000 as follows:

Unused cap percentage (44%)	x	Indexation increase ($100,000)

and her personal cap would become $1.644m (ie, original $1.6m 'locked in' personal cap + indexation of $44,000).

Assuming no other changes, Belinda could commence an additional account-based pension with up to $744,000 (ie, $1.644m - $900,000 balance of original account-based pension) at that time without penalty.

If she commenced a smaller second pension and used up just a bit more of her cap, she would be entitled to an even smaller proportion of the next round of indexation in a few years' time. Let's say her new pension reduced her unused cap percentage to 30%, she would only have an additional $30,000 added to her personal cap the next time the general cap was indexed to $1.8m.

Note that nothing Belinda can do in the future will increase her unused cap percentage above 44%, allowing her to benefit from a higher level of indexation. Let's say (for example) that she doesn't start that new second pension but instead stops her original pension entirely. Below we explain how the balance checked against her personal cap is adjusted to reflect this. However, even if it is adjusted so much that she is back to a position where she has effectively used none of her personal cap, she is ***still*** not entitled to the full indexation of $100,000 when the general cap is indexed.

What counts towards an individual's personal cap, and when?

Several things will count towards (ie, use) an individual's personal cap. These are known as 'credits' and the Appendix sets out when a credit will be made to the individual's personal cap, and the corresponding amount of the credit.

Importantly, as you will see from the Appendix, the 'value' [3] of the pension payable to the individual at a particular time will count towards their personal cap. This 'value' depends on the type of pension(s) paid to the individual, ie:

- if the pension is a type that can be **commuted (ie, stopped) in exchange for a lump sum payment**, the 'value' will be the total amount of the lump sum payment(s) that could be paid from the pension at that time.

  The types of pensions that can be commuted in exchange for a lump sum payment are quite limited and include:

  - account-based pensions;
  - allocated pensions; and
  - a special type of 'defined benefit' pension often known as 'flexi' lifetime or 'commutable' lifetime pensions. Note that the total amount of the lump sum payment(s) that could be paid from these pensions is *not* simply the value of the underlying account balance, rather it is the net present value of future pension payments (subject to a formula driven

[3] Note that the underlying tax components of the value of the pension are not relevant when determining how much of an individual's personal cap is used

upper limit imposed by the SIS Regulations).

- in contrast, if the individual has a type of pension that *cannot* be commuted in exchange for a lump sum payment, the value will be derived by a formula.

  These types of pensions, and the legislation that applies to them, will be discussed in more detail in a future edition of Heffron Super News.

  For now, however, the types of pensions that cannot be commuted in exchange for a lump sum payment are:

  - market linked (or term allocated) pensions; and
  - certain defined benefit pensions known as 'complying lifetime' or 'complying life expectancy' pensions.

  Generally these types of pension are payable from Federal or State Government funds to former employees, or are 'legacy' pensions paid from non-government funds (including SMSFs) to members who structured their superannuation pensions to access certain tax concessions under the former (since repealed) tax regime, or to exempt some of their super from the social security assets test.

What amounts will no longer count towards an individual's personal cap (ie, be reversed), and when?

In some cases, an event will occur that will cause an amount to no longer count towards an individual's personal cap. Such amounts are known as 'debits' and the Appendix sets out when a debit will be made from the individual's personal cap, and the corresponding amount of the debit.

A common debit, or reversal, will be the commutation of a pension, either in part or in full, and the 'value' of the amount to be reversed will depend of the *type* of the pension.

If the pension is a type that can be **commuted (ie, stopped) in exchange for a lump sum payment** [4], the 'value' of the reversal will simply equate to the commutation value. Note, however, that the commutation value of 'flexi' or 'commutable' lifetime pensions is not simply the amount of the account balance that is commuted, rather it will be determined based on a net present value calculation.

It is entirely possible for the commutation value (ie, the amount of the debit or reversal) to be larger than the amount standing to the credit of the individual's personal cap – in which case the amount standing to the credit of the individual will be a negative amount.

Consider the following example.

Peter commenced an account-based pension in July 2017 with an initial balance of $1.6m and as a result he activated his personal cap and locked in a lifetime personal cap of $1.6m. Several years later, Peter's account-based pension balance has grown to $1.9m due to investment earnings. He decides to fully commute his pension and roll it back to accumulation.

At the time Peter commenced his account-based pension, $1.6m counted towards his personal cap. At the time Peter commutes his pension, $1.9m (ie, the value of the pension balance at that time) is reversed from counting towards his cap. Immediately after the commutation, Peter has a balance of negative $300,000 counting towards his personal cap.

This means Peter has 'room' to commence another pension with a value of up to $1.9m (ie, his $1.6m 'locked in' lifetime personal cap plus an additional amount of $300,000 that arose from the negative amount counting towards his personal cap).

Special rules will apply to pensions that cannot be *cannot* be commuted in exchange for a lump sum payment [5], and the legislation broadly prescribes that the value of the reversal will be derived by various formulae. As mentioned above, these types of pensions, and the legislation that applies to them, will be discussed in more detail in a future edition of Heffron Super News.

What happens when an individual breaches their cap?

This depends on the type of pension(s) an individual has, ie:

- if the individual has *any* pensions that are of a type that can be commuted, **the individual will be required to commute one of those pensions (in full or in part) in order to fall within their lifetime cap.** The mechanics of this are discussed further below.
- in contrast, if the individual only has a type of pension that cannot be commuted in exchange for a lump sum payment (or at least not enough in other types of pensions to meet the commutation requirement), **no changes will be required to the non-commutable pension *account***, rather some of the tax concessions associated with that pension will be lost (eg, special taxes will be imposed on part or all of the pension payments). This will be

[4] An account-based pension, allocated pension, or special type of defined benefit pension often known as 'flexi' lifetime or 'commutable' lifetime pensions.

[5] Market linked (or term allocated) pensions and certain defined benefit pensions known as 'complying lifetime' or 'complying life expectancy' pensions.

discussed in more detail in a future edition of Heffron Super News.

- If the individual has both types of pension, they will effectively be forced to commute (say) their account-based pension(s) first and only have extra tax imposed on their (non-commutable) pension payments if there is no other way to deal with the excess (ie, they don't have enough in account-based pensions).

Mechanics

In cases where an individual breaches their personal cap and the pension *can* be commuted:

- The ATO will calculate an amount of 'notional earnings' to apply to the excess amount (this amount is essentially a proxy for the amount of earnings the 'excess' would have earned within the fund).
- The notional earnings on the excess amount will be calculated on a daily compounding basis, using an earnings rate based on the general interest charge (this averaged out to be 9.2% for 2015/16 but changes every year), from the time the excess occurred; until the earlier of:
    - o the breach of the cap being rectified by the individual by either:
        - ▪ partially commuting the pension and rolling a portion of the pension balance back to accumulation phase, or
        - ▪ by withdrawing a lump sum of the amount commuted from the super fund; or
    - o the Commissioner issuing a determination to the individual in respect of the excess.

  Importantly (unlike the rules around excess contributions) the individual can take action *before* receiving any instructions from the ATO – thereby minimising the period of time for which the notional earnings applies.
- The notional earnings calculated above, will be *fixed* and count towards the individual's personal cap – in other words the notional earnings will increase **the excess amount.** (Note that this doubling up effect stops once the Commissioner has issued a determination about the excess. This is so the Commissioner can issue a notice specifying the exact amount requiring action rather than individuals having to adjust it themselves for any time elapsed between the notice and their action to deal with it.)
- Unless the individual has already rectified the excess, the **Commissioner will issue a determination** to the individual in relation to the excess (including associated earnings) and the individual will be required to **remove the combined amount from a pension balance** (ie, as outlined above, by either rolling back a portion of the pension balance to accumulation phase, or by partially commuting the pension (ie stopping part of it) and withdrawing a lump sum from the fund).

  A notice will also be issued to the individual which outlines the default fund and default pension to which the Commissioner intends issuing a 'commutation authority' (this is essentially an instruction the ATO will issue to the fund to partially commute the pension). The individual will be able to make an election (in the approved form, within 60 days of the date of the determination) to commute a *different* pension should they wish to do so.
- The Commissioner will issue a 'commutation authority' to either the default fund, or the nominated fund (depending on which applies). The superannuation fund is required to reduce the pension balance within 60 days of the 'commutation authority' being issued to it. The fund must also notify the Commissioner and the individual (in the approved form) that it has done so (within that same 60 day period).
- **Where a fund fails to comply with a commutation authority**, the *full* amount of the pension balance (*not* just the excess) will be deemed to have ceased to be a pension for tax purposes from the start of the year (ie, 1 July) in which the fund failed to comply with the commutation authority and all later years. In other words, **the fund will not be entitled to a tax exemption in respect of investment earnings generated on that pension balance, even if it was only created by a very small excess**. Remember that this very harsh treatment only applies if the fund fails to take action within the required timeframe - it's not automatic for all excesses.
- In addition to having to remove the combined amount above from a pension balance, **the *individual* will be liable for tax on notional earnings**.

  To this end, notional earnings for tax purposes are calculated differently.

  In *addition* to the fixed amount of notional earnings calculated above (which were simply calculated to determine the amount that had to be removed from pension phase), notional earnings may continue to accrue (on a simple interest basis, using the general interest charge rate) from:

- the date the determination is issued; until
- the date the fund complies with the 'commutation authority'.

In some cases, where the individual has already removed the combined excess amount and the fixed amount of associated earnings from a pension balance prior to a determination being issues, no *additional* notional earnings will accrue.

- The individual will be issued with an assessment notice in relation to the overall amount of associated earnings and the general rate of tax that will apply is 15% (plus levies). This rate is designed to neutralise the advantage the individual receives via the fund from the pension tax exemption that applies to the fund's earnings due to the pension balance.

  Importantly, a higher rate of tax (ie, 30% plus levies) will apply in cases where an individual breaches their personal cap again in a future year. This rate is designed to discourage individuals *deliberately* exceeding their personal cap (by, say, commencing a further pension) in order to increase the amount of fund earnings that are exempt from tax – ie, it targets the group who believe the actual fund earnings will exceed the notional earnings rate.

  The tax is payable within 21 days of receiving the Commissioner's notice of assessment.

Special rules for 2017/18

In recognition of the fact that this is new territory, there are some special rules for relatively small breaches at 1 July 2017. Note that these only apply for pensions already in place when the new laws start – not pensions that commence on 1 July 2017 or later.

Essentially these special transitional rules provide that there will be no notional earnings and therefore no additional taxes if the breach is less than $100,000 and it is fixed before 31 December 2017.

Importantly, they don't allow individuals to leave additional amounts in their pension account – the excess still needs to be dealt with.

Strategy implications

Even just this one change – the $1.6m pension transfer cap – introduces many new strategy issues for pensioners.

We will cover these in detail separately in the coming months as many are also linked to other changes in the new legislation but just some strategy issues include:

- **Death**. In the past it has been possible to leave all of a couple's super in their SMSF until they have both died. Now that inheriting a spouse's super as a pension will be counted against the survivor's cap, there will be many circumstances where it will simply not be possible to do that. Some money will have to exit the super system on the death of the first member of a couple. There are numerous strategies to mitigate this (which will be covered in a future edition of Heffron SuperNews) but the landscape on death has definitely changed.

- **When to trigger the first assessment against the personal cap**. Given the way this affects future indexation it will be crucial to carefully decide when the first assessment against the individual's personal cap occurs (at which time it is locked in for life). We have identified a range of scenarios where careful management of this could add considerable value to an individual's ability to maximise their pension phase entitlements.

- **How payments from pensions are structured**. There are some key steps pensioners can take to ensure that at least some payments from their pension accounts are structured to "add back" to their $1.6m entitlement.

Conclusion

The above provides a brief summary of the legislation surrounding the $1.6m pension cap for pensions that can be commuted.

The next edition of Heffron Super News will deal with the $1.6m pension cap for pensions that *can't* be commuted.

Appendix

For pensions that <u>can be commuted</u> (ie, stopped) in exchange for a lump sum : What amounts <u>count towards</u> an individual's pension cap, and when?

When?	Amount?
1 July 2017 : pre-existing pensions only	The total amount of all the lump sum payments that could be paid from the pension at that time [6]
Commencement day of account -based pension	
Date a TRIS becomes fully accessible (ie, becomes an account-based pension)	
The day after the individual exceeds their personal cap	'Notional earnings' on any amount in excess of the personal cap
12 months after the day the individual becomes entitled to a reversionary pension	The total amount of all the lump sum payments that could be paid from the *deceased's* pension at the time of death

For pensions that <u>can be commuted</u> (ie, stopped) in exchange for a lump sum : What amounts <u>are reversed from</u> an individual's pension cap, and when?

When?	What amount will be reversed?
On the day an individual commutes (ie, stops) part or all of a pension (either by rolling back part or all of the pension to accumulation phase, or by paying out the commuted amount as a lump sum payment)	The commutation value of the amount that is either rolled back to accumulation phase, or paid out as a lump sum
If a fund *fails* to comply with a commutation authority issued by the Commissioner (ie, to commute an amount of pension for a member who breaches their personal cap), at the end of the period in which the fund was required to comply with the authority	The 'value' of the pension account balance at that time (ie, essentially the commutation value of the pension)
On the day a 'payment split' is affected if an individual splits part of their superannuation with their spouse as a result of a relationship breakdown (pursuant to the Part VIIIB of the Family Law Act 1975)	The 'value' of the amount split from the pension balance
On the day when an individual makes a contribution of an amount they receive as a result of a structured settlement or orders for personal injuries, a debit is made at the later of: • the time the contribution is made; and • the first time the individual has an amount credited to their personal transfer balance cap.	The amount of the contribution made

[6] In the case of 'defined benefit' pension often known as 'flexi' lifetime or 'commutable' lifetime pensions. Note that the total amount of the lump sum payment(s) that could be paid from these pensions is *not* simply the value of the underlying account balance, rather it is the net present value of future pension payments (subject to a formula driven upper limit imposed by the SIS Regulations).