A super reform checklist for 1 July 2017

New super reforms will apply from 1 July 2017. Until then, there are some limited opportunities for your clients. This checklist provides you with six areas to focus on before 1 July 2017.

1. Maximise concessional contributions

The concessional contributions annual cap will reduce to $25,000 for everyone from 1 July 2017. Currently they are $30,000 for those under 50 and $35,000 for those over 49.

Maximise concessional contributions prior to 1 July 2017 through salary sacrifice or personal concessional contributions (subject to the 10 per cent rule).

For SMSFs, ensure any contribution parking strategies are modified for the 2017/18 financial year to avoid excess contribution issues.

Removing the 10 per cent rule impacting concessional contributions

The 10 per cent rule will be removed from 1 July 2017. This will empower individuals to make personal deductible contributions, where formerly, because more than 10 per cent of their income was sourced from employment, they were not entitled to make deductible contributions. This will be important for EOFY campaigns for clients who:

- realise capital gains
- cash out leave entitlements
- receive bonuses, or
- have irregular employment .

Catch–up or carry-forward concessional contributions

The new concessional contributions rules allow individuals with total superannuation balances below $500,000 to use their unused concessional caps for a period of five years.

Set to commence from 1 July 2018, this will be important for clients who:

- realise capital gains
- cash out leave entitlements or receive a bonus
- have an irregular employment history
- receive an inheritance

2. Maximise non concessional contributions

Annual non-concessional contributions reducing to $100,000

From 1 July 2017, the annual non-concessional contributions (NCC) cap will be lowered to $100,000 (from the current $180,000) and will introduce a new constraint so that individuals with a total super balance of $1.6 million or more will no longer be eligible to make non-concessional contributions.

Bring-forward rule

Individuals under age 65 will still be eligible to bring forward three years' worth of non-concessional contributions. Under the new rules, from 1 July 2017, the new three year bring-forward cap will be $300,000 (down from the current $540,000 cap).

Transitional measures will apply to those who trigger the bring-forward rule in 2015/16 and 2016/17 and have not fully used their NCC bring-forward amount before 1 July 2017. The remaining bring-forward limit will be reassessed on 1 July 2017 to reflect the new lower annual caps.

Therefore from 1 July 2017:

- A client who triggered the bring-forward cap in 2015/16 will have their cap reduced from $540,000 to $460,000 ($180,000 for 2015/16 + $180,000 for 2016/17 + $100,000 for 2017/18).
- A client who triggers the bring-forward cap in 2016/17 will have their cap reduced on 1 July 2017 to $380,000 ($180,000 for 2016/17 + $100,000 for 2017/18 + $100,000 for 2018/19).

Clients who have not contributed the maximum allowed under the existing NCC cap ($180,000 annually or $540,000 over three years) should consider doing so before 30 June 2017.

Work test remains

As is currently the case, individuals aged between 65 and 74 will be eligible to make annual non-concessional contributions if they meet the work test (that is they work 40 hours within a 30 day period each financial year), but will not be able to bring forward contributions.

Those with total super balances over $1.6 million will not be able to make further non-concessional contributions. The individual's total superannuation balance is taken from 30 June of the previous financial year. Where total super balances are close to $1.6 million, the bring-forward provisions may be restricted.

As 1 July 2017 is the start date for these changes, clients who have total super balances already in excess of $1.6 million should consider maximising their non-concessional contributions in 2016/17.

3. Transition to retirement pensions

From 1 July 2017:

- Transition to retirement income streams (TRISs) earnings are no longer tax exempt
- Regular pension payments can no longer be treated as a lump sum for tax purposes

TRISs were introduced in 2007 to help older Australians transition towards retirement by supplementing income lost through reduced working hours. However it also facilitated strategies such as 'income swapping', which involved maximising salary sacrifice contributions, and replacing the income sacrificed to superannuation by commencing a TRIS.

This is seen by the Government as a wealth building strategy that is not in line with the purpose of superannuation.

What's changing for TTR pensions?

Under the new rules, only income streams that are in retirement phase will benefit from earnings tax exemption. TRISs are specifically excluded from the definition of a 'retirement phase' income stream.

Additionally, the tax regulation permitting a client to elect to treat pension payments as lump sums will be removed. This means that the Taxable element taxed portion of regular pension payments for those aged between preservation age and 59 years will be taxed at marginal tax rates (less 15% tax offset).

Example:

David is 58 years old and has reached preservation age. He commenced a $300,000 TRIS on 1 July 2015. His TRIS is comprised of 100% Taxable component - element taxed. David's annual salary (excluding super) is $100,000. He decides to salary sacrifice $25,500 to maximise his concessional contributions cap. He draws a pension equal to the minimum of $12,000 to replace his income. Assume David's TRIS earns $9,000 of income per annum.

Under current rules, the benefit of carrying out the income swap can be summarised as follows:

Personal income tax savings (less 15% contributions tax payable in the super fund): $5,362.50

TRIS earnings tax savings : $1,350

	Before income swap	After income swap
Net cash flow	$73,053	$70,741
Estimated tax savings	-	$6,713
Contributions to super	$8,075	$17,750[1]

On 1 July 2017, the earnings exemption no longer applies to the TRIS. David is no longer able to elect to treat the pension payments as lump sum super payments. Although the concessional cap will reduce to $25,000 it is assumed that David continues to salary sacrifice $25,500. This is to isolate the impact of the loss of earnings exemption and the ability to use the low-rate cap to offset the tax on pension payments.

	Before income swap	After income swap
Net cash flow	$73,053	$68,348
Estimated tax savings	-	$2,970
Contributions to super	$8,075	$17,750[1]

The effect of the super changes, as shown in the table above is to significantly reduce the tax savings of the strategy. As the $12,000 pension drawdown is now subject to tax, this results in additional tax of $2,393. The loss of the pension earnings tax exemption results in additional tax of $1,350.

Clients have the opportunity to take advantage of the income swap strategy until 30 June 2017. However this strategy should be reviewed given the changes that will come into effect next year. For example, in the case study above the salary sacrifice amount will need to be reduced to reflect the lower cap. He may also need to consider winding back the TRIS and reverting to a simple salary sacrifice strategy.

1 $9,500 SG plus $25,500 salary sacrifice less $5,250 contributions tax less $12,000 taken out as pension payment

4. Re-contribution strategy

The super re-contribution (recycling) strategy has been retained. This strategy is likely to become even more valuable for your clients to implement as part of their retirement planning.

For your clients this may:

- improve the tax effectiveness of a superannuation based income stream from age 56 to 59, and
- minimise the tax paid upon death (for example, by non-dependent children), for estate planning purposes.

From a timing perspective, clients implementing this strategy in 2016/17 still have the ability to withdraw and re-contribute under the bring-forward rule of $540,000 or $1,080,000 per couple. This assumes:

- a condition of release is met
- clients are aged 60 or over
- the bring-forward rule hasn't been triggered in the past two years.

From 1 July 2017, the non-concessional cap reduces to $100,000 per annum and the three year bring forward amount reduces to $300,000 (with some transitional provisions).Where spouses are involved, there are many reasons why clients may want to consider contributing to a spouse's super, including:

- Equalise the super of both members.
- A couple (aged between preservation age and 60) can effectively maximise their low rate threshold on super withdrawals relating to the taxable component.
- Where members of a couple have a significant age difference, by re-contributing towards the older spouse's super fund, they may be able to access tax-free superannuation sooner.
- Improve means testing for Centrelink clients where superannuation is re-contributed to a younger spouse's super fund who is less than pension age.
- Increase the amount that each member of a couple can hold as income streams according to the rules to limit pension balances per person to $1.6 million.
- To enable clients to reduce their super balance below the $500,000 limit, to let them make catch-up concessional contributions from 1 July 2018.
- With rules to restrict NCCs only to clients with total super balance below $1.6 million, re-contribution to a spouse's super fund helps to allow clients make further NCCs in the future.
- Hedge against legislative risk that may further change the ability to accumulate retirement savings or taxation of benefits.
  - Don't forget to consider estate planning and separation concerns before providing advice.

Before implementing this strategy, consider the following:

- Any withdrawals from super (with taxable components) prior to age 60, increases a client's assessable/ taxable income, which could impact various tax and social security benefits, which are assessed based on the taxable income definition.
- Reduced NCC caps from 1 July 2017 will reduce the size of the re-contribution and bring-forward amounts.
- From 1 July 2017, the anti-detriment payment for death benefits will no longer be available. The removal of the anti-detriment payments reduces one of the existing negative reasons for the implementation of the re-contribution strategy (eg, if a client dies after 1 July 2017 the anti-detriment payment for death benefits will no longer be available).
- Because of the proportioning rule (between taxable and tax-free components), it may be worthwhile to re-contribute to a separate super fund before conversion to income streams. This may allow the distribution of tax-free component to death benefit non-dependants and the taxable component in another super interest can flow to death benefits dependants (tax-free). **Where clients plan to make non-concessional contributions before a recycling strategy, the operation of the proportional rule on withdrawal may hinder the strategy.** Consider the following case study:

Case study

Ken, age 55, has $400,000 (all taxable components) in his ABC super fund. He plans to make a non-concessional contribution of $180,000 in 2016/17.

During 2017/18 (assume super balance is $580,000), Ken plans to withdraw and re-contribute $300,000 back into the account (under the reduced bring-forward contribution limit).

Due to the proportioning rule, $93,103 (31%) of the withdrawal will be from tax-free component and $206,897 will be from the taxable component.

Ken's tax-free component in ABC fund reduces to $86,897 ($180,000 less $93,103) after the withdrawal but before the re-contribution. However, once he re-contributes the $300,000, this will increase the tax-free component in the ABC fund to $386,897 at the end of the recycling strategy.

Alternatively, if Ken was to first make the contribution of $180,000 to another super fund (XYZ super fund), then $300,000 (all taxable) can be withdrawn from the ABC fund during 2017/18 and re-contributed to the same fund (under the 'bring forward' rule), providing $300,000 of tax-free component is in the ABC fund. The $180,000 in the XYZ fund can then be rolled over and merged with the ABC fund. Under this alternative option, $480,000 is the resultant tax-free component in the ABC fund (instead of $386,897, an increase of $93,103 as compared to the first option).

5. Death benefits

$1.6 million cap

Death benefits paid as income streams will generally count towards the $1.6 million balance transfer cap. Anything over $1.6 million will ordinarily need to be paid as a lump sum and leave the superannuation system.

Advisers may want to review clients who have expected death benefits above the $1.6 million cap to determine if it is more appropriate to hold insurance outside of super and to review the interaction of super as part of a client's estate plan.

Reversionary pensions

Where a pension is established as a reversionary pension, the balance of the reversionary account is counted against the reversionary beneficiary's transfer balance cap.

However, the amount of the reversionary pension will not count against the reversionary beneficiary's balance transfer cap until 12 months after the income stream benefits first become payable. This provides the reversionary beneficiary with time to adjust their affairs following the death of the pensioner

Where a death benefit is not established as a reversionary pension but the death benefit is paid as a pension, the new death benefit is also counted against the beneficiary's transfer balance cap at the time the pension is commenced.

Advisers should review clients who do not have reversionary pensions in place to see if it is beneficial to change the pension to reversionary to take advantage of the longer grace period for counting towards the transfer balance cap.

Child death benefits

There is special treatment for death benefits paid as income streams to children. A child death benefit recipient will generally be able to receive their share of the deceased's retirement phase interest. The child will then receive a new transfer balance cap when they are eligible to receive a super income stream benefit in their own right.

The child will inherit their parent's balance transfer cap, adjusted to reflect their share of the total death benefit. If a parent with a balance transfer cap of $1.6 million dies leaving their benefit to be allocated equally between two minor children, each child will be able to commence a death benefit pension up to their modified balance transfer cap of $800,000.

Rollover of death benefits

From 1 July 2017 death benefits that are eligible to be received as an income stream will be able to be rolled over to a new fund. This will provide flexibility for dependants who may receive death benefits from funds that do not offer death benefit pensions and also allow beneficiaries to choose a fund that meets their personal needs.

Death benefits rolled over will be recorded as death benefit income streams in the new fund. They will not be able to be combined with a member's retirement phase pensions and will not be able to be rolled back to accumulation phase.

This is welcome relief for advisers who may now recommend funds that don't pay death benefits if the other features suit the member's needs.

Anti detriment

The anti-detriment payment will be removed for people who die after 1 July 2017. For people who die before 1 July 2017, they may still qualify for an anti-detriment payment on a super lump sum death benefit if paid before 1 July 2019. This provides super fund trustees and members with a small window to finalise death benefit claims for those who die before 1 July 2017.

6. $1.6m transfer balance cap

From 1 July 2017, a $1.6 million Transfer Balance Cap will be introduced to limit the amount of super that can be transferred to retirement phase. This will reduce the amount of super retirement income streams benefiting from tax-free earnings. Existing super retirement income streams with balances in excess of $1.6 million will be required to commute the excess (either back to accumulation phase or as a super lump sum withdrawal), and given the choice to elect to apply CGT relief.

The following case study illustrates how the transfer balance cap will affect those with balances over $1.6 million.

Case study

Commencing retirement phase income streams (RPIS) from 1 July 2017

Melinda age 65, has super in accumulation phase of $2.5 million on 30 June 2017. She retires on 31 July 2017 and the maximum amount that she can transfer to retirement phase is $1.6 million. Assuming that earnings on super funds equate to 4 per cent per year, the impact of the change is shown in the following table:

	Without Transfer Balance Cap (current rule)	With Transfer Balance Cap (from 1 July 2017)
Retirement Phase Income Stream	$2.5 million	$1.6 million
Accumulation Phase super	$0	$900,000
Income stream earnings (4 per cent)	$100,000	$64,000
Tax on income stream earnings	**$0**	**$0**
Accumulation phase super earnings (4 per cent)	$0	$36,000
Tax on accumulation phase super earnings	**$0**	**$5,400**

Earnings from RPISs do not affect the $1.6 million cap, nor do pension payments. Should Melinda's RPIS increase in value to $1.8 million, earnings of the RPIS are still exempt from tax. Assuming the earnings rate remains at 4 per cent, pension earnings of $80,000 remain exempt from tax. Lump sum withdrawals and rollovers out of retirement phase income streams will reduce the amount counting towards the transfer balance cap by the dollar amount withdrawn or rolled over.

Advisers will need to review cash flow funding for clients, and consider reducing pension payments to the minimum drawdown to preserve RPIS balances. If possible, additional funds should be accessed from accumulation phase super or other assets (subject to transaction costs and possible CGT).

Using the previous case study, if Melinda's RPIS balance reduced to $1.2 million, she will not be able to transfer any more funds to retirement phase as she has already used up her $1.6 million transfer balance cap.

Clients with existing super income streams with balances in excess of $1.6 million

If a client is already in receipt of an account-based pension, and the balance is expected to be in excess of $1.6 million by 1 July 2017, they will be required to reduce their pension balance to $1.6 million or less before 1 July 2017. Failure to do so could result in excess transfer balance tax, unless they qualify for transitional relief. Please refer to our *fair and sustainable super reform – a technical guide* for further information about excess transfer balance transitional relief and the operation of the excess transfer balance tax.

The balance of the income stream can be reduced by commuting the excess amount back to accumulation phase or by withdrawing funds out of the super system.

Case study

Jay is retired and currently has a $4 million super income stream. Jay needs to reduce the balance of his income stream to at least $1.6 million by 1 July 2017. On 20 June 2017 Jay commutes $2 million to accumulation phase and withdraws $400,000 to comply with the Transfer Balance Cap. On 1 July his pension balance is $1.6m and he does not have any excess transfer balance amounts.

Limitation on ability for SMSFs to use segregation

SMSFs members with total super balances over $1.6 million and in receipt of RPIS payments are no longer allowed to use the segregated method from 1 July 2017. This is regardless of whether the member with $1.6m has this outside the SMSF. This means that from 1 July 2017, the SMSF must calculate exempt current pension amounts using the proportionate (unsegregated method). Please refer to our comprehensive guide on the super reforms for more information.

Transitional CGT relief is available when commuting excess transfer balances between 9 November 2016 and 30 June 2017.

Transitional CGT relief is available where super retirement income streams (such as account-based pensions) are commuted to comply with the $1.6 million transfer balance cap, or to comply with TRIS reforms held by complying super funds (both large funds and SMSFs/SAFs). The rules for transitional CGT relief is complex and will vary depending on whether segregated or unsegregated methods are used before commuting the pension.

The decision to use CGT relief as described in the following case study must be done in an approved form (which is not currently available) at the time the super fund completes their tax return for the 2016/17 financial year. Importantly, while the use of these relief provisions is optional, if a super fund elects to use relief the decision is irreversible.

Transitional CGT relief – segregated current pension assets

A super fund is eligible to elect to apply transitional CGT relief if the following requirements are met:

- The CGT asset is a segregated current pension asset of the fund on 9 November 2016
- As a result of the commutation, the CGT asset is no longer a segregated current pension asset of the fund
- The asset remains held by the fund for the remainder of the financial year.

If the trustee chooses to apply for CGT relief for a qualifying asset, the asset is deemed to be sold immediately before the commutation date and re-acquired on the commutation date. If a gain arises from the deemed sale, the gain remains exempt from tax as the gain is realised in the segregated current pension phase. The cost base and ownership period for the asset is reset to the value and date at the time of commutation. Please note that the 12 months required to qualify for CGT discount is also restarted to commence from the commutation date.

Case study

Jocelyn and Malcolm are members of their own SMSF. Both are retired and all super interests in the SMSF are in retirement phase. Jocelyn's pension balance is $2 million and Malcom's $5m. SMSF assets comprise of $6.5 million in residential property and $500,000 in liquid assets. The cost base for the property is $3 million and the property was acquired by the SMSF 10 years ago.

Jocelyn will need to commute $400k of her pension and Malcolm will commute $3.4 million from his pension on 20 June 2017. As trustees of the fund they decide to elect for transitional CGT relief on the residential property. This results in a deemed sale of the property. The capital gain arising from the deemed sale is $3.5 million. As the property was a segregated current pension asset prior to 20 June 2017, the $3.5 million gain is exempt from tax. The cost base for the property will be reset to its value on 20 June 2017 ($6.5 million).

Transitional CGT relief – unsegregated (proportional) method

A super fund using the unsegregated method is eligible to elect to apply transitional CGT relief if the following requirements are met:

- The CGT asset was never a segregated current or non-current pension asset of the fund on 9 November 2016
- The exempt current pension income (ECPI) percentage of the fund is more than zero in the 2016/17 financial year
- The asset is held throughout the period from 9 November 2016 to 30 June 2017.

If the trustee chooses to apply for CGT relief for the asset, the CGT asset is deemed to be sold immediately before 1 July 2017 and reacquired just after the sale. If a gain arises from the deemed sale, the trustee of the fund can choose to account for the gain in the 2016/2017 financial year or choose to defer the gain until the asset is sold. The deferred gain is calculated taking into account any relevant CGT discount and ECPI percentage for the 2016/2017 financial year. The cost base and ownership period for the asset is reset to the value and date just after the deemed sale (effectively start of business on 1 July 2017).

Case study

Jason (63) and Fiona (49) are members of their own SMSF. Jason is retired and his retirement phase income stream is valued at $2 million on 30 June 2017. Fiona is still working and has $2 million in super in accumulation phase. SMSF assets comprise of $3.2 million in residential property and $800,000 in other assets. The cost base for the property is $2.9 million (property was acquired by the SMSF 2 years ago). The SMSF uses the unsegregated (proportionate method).

Jason will need to commute $400,000 of his pension. As trustees of the fund they decide to elect for transitional CGT relief on the residential property. This results in a deemed sale of the property at close of business 30 June 2017. The capital gain arising from the deemed sale is $300,000. The ECPI percentage for the fund will be just under 50 per cent, as the commutation of Jason's pension will occur before the end of the financial year, resulting in a slightly lower average pension balance.

Assuming the SMSF does not have any carry forward capital losses, the ECPI of the fund is approximately $100,000[2]. The net assessable portion of the gain is estimated to be $100,000.

The fund can bring the above gain to account in the 2016/2017 financial year or defer the gain. The amount of the deferred gain in this case will be approximately $100,000. Should the property be sold in the future, the $100,000 deferred amount will be assessed as income in the financial year that it is sold, but it will not be reduced by any applicable CGT discount or ECPI percentage applicable in that year. The cost base for the property will be reset to $3.2 million and the ownership period will commence 1 July 2017.

2 $300,000 less 1/3 CGT discount multiplied by ECPI percentage of 50%

Should a fund always choose to apply transitional CGT relief?

Not necessarily. In the previous case studies, a gain would arise from the deemed sale. If a loss arises instead, the fund would be better off not electing to apply relief, as realising a capital loss through this deeming method in a fund with RPIS is not an efficient use of these losses.

Under the segregated method, the capital loss would be realised in the segregated current pension phase and therefore used to offset gains which are already tax exempt. Under the non-segregated method, the capital loss would be used to offset gross capital gains before ECPI is calculated, resulting in a portion of the loss being effectively wasted on gains which would otherwise be reduced by ECPI.

Where members do not have an SMSF, advisers need to check with the relevant income stream provider in regards to whether the trustee will elect to apply for CGT relief. **Please note that transitional CGT relief is optional – trustees are not required to elect to apply CGT relief.**

If you would like further information, please call our office.

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WMA-21227