Heffron SuperNews

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Heffron SMSF Solutions

Problem solved

The $1.6m pension transfer balance cap was discussed in Issue #133 of Heffron SuperNews. This obviously has a profound impact on some SMSF members. But the draft legislation also influences how funds themselves are taxed. This edition of SuperNews explores some new CGT relief as well as amendments relating to when an SMSF can segregate assets.

Introduction

This edition of Heffron SuperNews discusses two major changes in the current program that affect superannuation funds themselves, rather than applying directly to a fund's members. Of course, the impact is the same – anything that affects a fund's tax treatment ultimately flows through to its members and nowhere is this more obvious than in an SMSF.

The two changes covered here are:

- **CGT relief**. Under current law, any capital gains realised on the disposal of assets that underpin pension accounts (including TRIS accounts) are exempt from tax - even if those gains accrued over many years, including the years before the pension (or TRIS) started. Both the new rules for TRISs and the $1.6m pension transfer cap will constrain funds that might previously have benefited significantly from this provision and hence some special relief to protect gains built up *before* the changes has been included in the legislation;
- **Segregation**. Currently pension funds that also have accumulation balances can choose whether they obtain their tax relief in pension phase by "segregating" their assets (setting aside specific assets to support pension accounts and claiming all the income on these assets as tax exempt) or "pooling" (sharing all the assets between all accounts and claiming a proportion of all fund investment income as tax exempt). In the new regime, some funds will be specifically denied the right to adopt the first approach and will have to pool their assets.

Capital gains tax

The issue

From 1 July 2017:

- Many individuals will need to roll back some of their pension to accumulation phase to comply with the new $1.6m pension transfer balance cap (ie, "pension cap"). Consequently many clients who might previously have enjoyed years of being "fully in pension phase" will return to a hybrid position where they are subject to tax on at least some of their fund's investment earnings; and
- as discussed in an earlier SuperNews, investment earnings on assets underpinning a TRIS balance will no longer be exempt from tax – ie, they too will become taxable.

Clearly the impact of the above measures on capital gains is particularly detrimental.

Introducing them without any CGT relief would potentially mean that an asset sold on 2 July 2017 would have given rise to capital gains tax while the same asset sold two days earlier would not.

Proposed relief

To counter this disadvantage the legislation includes transitional provisions that provide relief for capital gains accumulated before 1 July 2017.

Conceptually, the relief is designed to ensure that when an asset is sold on or after 1 July 2017:

- capital gains that accrued **after** this date will be taxable / tax exempt in accordance with the new rules; while
- capital gains built up **before** 1 July 2017 will get some recognition of the fact that they would have been wholly or partly tax exempt under the old rules.

It does this by allowing funds to choose to **reset the cost base** of certain assets during the period 9 November 2016 – 30 June 2017.

An aside – what's the relevance of 9 November 2016?

This is the date the legislation was tabled in Parliament. It immediately triggered an important period (9 November 2016 – 30 June 2017). **Action taken during that period can compromise (or help) a client's position in relation to the CGT relief.**

> It is therefore vital that these rules are understood immediately – it is not something that can be deferred until 1 July 2017.

Note also that assets sold in 2016/17 are not affected by the relief or the new rules – life continues as normal in that sense until 1 July 2017.

The CGT Relief in detail

There are two paths to obtaining the CGT relief and both provide a very different method for calculating the relief and therefore a different outcome.

They do have some points in common, however:

- whichever method is used (or even if a fund uses a combination of the two) it only **applies to assets actually held at 9 November**, not new assets bought since that time;

- the fund specifically chooses to **"opt in"** to the relief rather than it being an automatic process. The opt in needs to occur on or before the day the fund's 2016/17 tax return is due to be lodged **and will be irrevocable.** Note that the relevant date is the due date of the return – presumably funds that do not lodge on time will still need to make this election by the due date in order to be eligible even if they lodge their return late; and
- it operates on an asset by asset (and even parcel by parcel) basis so a fund can make different choices about different assets.

Path 1 : Segregated method

This path is only applicable where a fund asset was a "segregated" pension asset on 9 November 2016 and stops being segregated at any point before 1 July 2017.

A segregated pension asset is one that has been set aside to solely support a pension balance either because:

- the fund has a combination of pension and accumulation balances and maintains specific and separate bodies of assets to underpin them; or
- the fund is entirely in pension phase (other than defined benefit pensions) and so all of the assets of the fund are effectively segregated by default.

Effectively this means the **pension needed to be in place before 9 November 2016** – without a pension there are no segregated pension assets.

Funds taking this approach adopt the CGT relief on **just the assets that stop being segregated pension assets during the period 9 November 2016 – 30 June 2017**.

For those assets, the cost base is reset to the market value of the asset at the time it stopped being a segregated pension asset.

(Essentially, imagine the asset had been sold and repurchased on that same day).

The remaining assets (eg, assets that remain segregated pension assets throughout the year) will continue to be entirely exempt from tax on earnings during 2016/17 but will not be eligible for a cost base reset.

Consider the following example.

Within their SMSF, Tom (retired) has an account-based pension of $2.6m and Lauren has an accumulation account. A number of assets are segregated solely to support Tom's pension (ie, they are segregated pension assets).

To comply with the $1.6m pension cap, Tom partially commutes (ie, rolls back) $1m of his pension to accumulation phase on 30 June 2017.

To give effect to this, the fund moves a specific asset with a market value of $1m out of the segregated pool of exempt pension assets.

The cost base for this asset is $750,000, ie it has already accrued unrealised capital gains of $250,000. To ensure that this accrued capital gain is not taxed when the asset is eventually sold, the fund chooses to apply the CGT relief arrangements to this asset, resetting its cost base to $1m.

Note that because the fund only stopped segregating the specific $1m asset, **the remaining segregated pension assets do not receive the CGT relief** (ie, there is no cost base reset to the remaining segregated pension assets).

Note also that the date on which the cost base is reset is the date on which the asset was transferred out of the segregated pension assets. If this occurs on 1 March 2017, the effective date of the change in cost base and the date on which the market value would have been determined for this purpose would also be 1 March 2017.

Continuing the example

A few years later the $1m asset is sold for $1.5m.

The $500k gain built up *after* 1 July 2017 is subject to tax but:

- as long as the sale occurs more than 12 months after the date the cost base was reset (ie, 12 months after 30 June 2017 or 1 March 2017 if applicable in the above example) the usual 1/3 discount applies;
- part of the gain will be subject to tax based on the actuarial % at the time. (As an aside – the fund won't be able to calculate its tax exemption using the segregated method in 2018/19 because other, quite separate, new rules prohibit this for certain SMSFs – see below).

Let's say the tax exempt actuarial % is 55% at the time the asset is sold. The following amount will effectively be subject to tax:

$$\$500,000 \times 2/3 \times (100\% - 55\%) = \$150,000$$

Are there any other options?

In the example above, Tom **moved a specific asset** with a market value of $1m out of the segregated pool of exempt pension assets on 30 June 2017 (ie, at the time he partially commuted his pension and rolled $1m back to accumulation phase). The act of moving that asset allowed him to choose to reset the cost base of that asset to its market value on that day.

An alternative approach would be for Tom to still roll back $1m from his pension account to accumulation phase on 30 June 2017 **but take no specific action in relation to his assets.**

This would mean **all** his assets would stop being segregated pension assets at

the time he partially commutes his pension – this is because at that moment the assets are no longer **solely** underpinning his pension, rather the assets then underpin a *combination* of both pension and accumulation accounts.

In cases like this, the **CGT relief is available to all the previously segregated pension assets** (not just a specific asset, as is the case when a specific asset is moved out of the segregated pool of exempt assets), The date on which the cost base is reset (and therefore the date on which the market value would have been determined) is the date on which the fund stops segregating its pension assets. In the example above, this date is 30 June 2017 (when Tom partially commutes his pension), but it could occur earlier (see below).

As the CGT relief will be available to each and every previously segregated pension asset, we expect this alternative approach would give Tom a far better result long term.

This alternative approach is easy to implement for Tom – he needs to reduce his pension balance to $1.6m by 30 June 2017 and simply getting the right advice to stop segregating will ensure he gets the best possible outcome.

But beware, while it is easy to implement, it is also incredibly easy to do the wrong thing and miss the CGT relief opportunities!

Tom's biggest risk is perhaps that he will accidentally stop segregating too early and trigger his cost base reset date (and market value) earlier than he intends. Perhaps:

- the fund accepts a contribution for him and he doesn't keep it separate from his segregated pension assets; or
- he hears about the general prohibition on segregation (see below) for 2017/18 and beyond and stops treating his and Lauren's assets separately throughout 2016/17 rather than starting late in the year or on 1 July 2017.

The other risk for someone like Tom is that he won't take any action at all. The CGT relief only applies to assets that ***stop*** being segregated during the period 9 November 2016 – 30 June 2017. This is unlikely to happen in Tom's case because he ***needs to take action*** by 30 June 2017 simply because he exceeds his $1.6m pension cap. As outlined above, Tom's action will either cause a specific asset to be moved out of the segregated pool of exempt pension assets or, alternatively, the assets of the fund would stop being segregated pension assets at the time he rolls a portion of his pension back to accumulation phase. But what if:

- for whatever reason Tom isn't aware that he needs to take action and therefore doesn't change his pensions until after 1 July 2017. He would miss out on the CGT relief; or
- Tom's pension was not a "full" account-based pension but was instead a transition to retirement pension. Because these pensions are not subject to the $1.6m pension cap, Tom would not need to restructure his pension to meet the cap by 30 June 2017. While taking no action would make sense purely for the purposes of the $1.6m cap, and would be perfectly legal, it would mean he would miss out on the CGT relief.

Path 2 : Proportionate method

The second path is referred to in the legislation as the "proportionate" method. Broadly speaking it is intended for funds that don't segregate assets. Instead, these funds obtain an actuarial certificate to claim a tax exemption for investment income on pension assets, although like most things in superannuation it's not ***quite*** that simple.

To be eligible for CGT relief under the proportionate method for a particular asset:

- the fund must have a 2016/17 actuarial certificate with a tax exempt % of more than 0%; and
- the asset must not have been a segregated pension asset or a segregated accumulation asset at any time between 9 November 2016 and 30 June 2017.

Interestingly, the particular provisions that relate to this method don't stipulate that the fund must have had pension accounts in place before 9 November 2016. (Remember this was an important requirement for segregated funds)[1]. Consequently, CGT relief under the proportionate method would be available in relation to any pension (including a

[1] This may well have been unintentional and may be corrected. The provisions specifically exclude assets that were "segregated non-current assets" during the period 9 November 2016 – 30 June 2017. Non-current assets are usually assets solely supporting accumulation balances – ie, all fund assets if no pensions were in place on 9 November 2016. However, for an asset to qualify as a non-current asset it must be the subject of an actuarial certificate (note, this is a special type of actuarial certificate – not a "%" certificate). If the trustee doesn't obtain this special actuarial certificate, the asset is not a non-current asset. These special actuarial certificates are not common, and are usually obtained for accumulation assets when a fund has a combination of segregated pension assets, pooled assets (supporting both pension and accumulation balances) and segregated accumulation assets.

TRIS) that commences before 30 June 2017.

(It is worth noting that in the Explanatory Memorandum to the Bill, Treasury were at pains to highlight the anti-avoidance provisions (often referred to as "Part IVA" because this is the part of the tax legislation which describes them) and to clarify that they would apply to the CGT Relief. This would suggest that anyone who started a pension purely to access the CGT Relief would be at risk – although remember this applies generally to any action that is entirely tax driven.)

Essentially, once again, under the proportionate method the cost base of the asset would be reset by assuming the asset had been disposed of, for its market value, immediately before 1 July 2017 and simultaneously reacquired by the fund for that value. Not only would the cost base be reset but the period from which 12 months is measured (for the purposes of CGT discounting) would also reset.

Note the timing of the reset under the proportionate method (ie, immediately before 1 July 2017) is different to the segregated method – under the latter the reset can occur at any time between 9 November 2016 and 30 June 2017, and is triggered by certain acts.

When a fund uses the proportionate method, a portion of each asset underpins a combination of both pension and accumulation accounts. Consequently, the **CGT relief under this method is available to <u>all</u> fund assets as long as they have not been specifically segregated to provide pension or accumulation benefits**.

However, in recognition that the fund has accumulation balances, there is an **extra step** after the cost base is reset. Under the proportionate method, the fund must ***also*** calculate a "notional gain" amount that relates to the accumulation liabilities at 30 June 2017. This notional gain amount is worked out using the 2016/17 actuarial % as shown in the example below.

Consider the following example.

Within their SMSF, Cathy has an account-based pension ($2m) and Andrew has an accumulation account ($1m). The SMSF holds a single asset with a market value of $3m and the fund uses the proportionate method to work out the tax on income produced by that asset. In 2016/17, the tax exempt actuarial % for their SMSF is 66.67% (on the basis that throughout the year, Cathy's pension balance accounted for roughly 2/3rds of the fund).

To comply with the $1.6m pension cap, Cathy partially commutes (ie, rolls back) $400,000 of her pension back to accumulation phase on 30 June 2017.

The cost base of the fund's single asset is $2.82mand it has therefore accrued unrealised capital gains of $180,000.

The fund chooses to apply the CGT relief arrangements to this asset, resetting its cost base to $3m on 30 June 2017. (Importantly, note that the cost base of the *whole* asset is reset – there is no apportionment to reflect that a portion of the asset supports an accumulation account).

This reset triggers a notional gain on the asset of $180k at 30 June 2017.

Using the actuarial % for 2016/17, 66.67% ($120,000) is attributable to the pension account and $60,000 relates to the accumulation account. If applicable, the fund applies the CGT discount at 30 June 2017 to the accumulation portion of this notional gain (reducing it to $40,000).

This **fund must pay tax on the notional gain attributable to the accumulation account** (ie, $40,000, assuming the CGT discount applied at 30 June 2017) at some point.

When is the tax paid?

The Fund will need to <u>pay tax on the notional gain triggered by resetting the cost base with its 2016/17 tax return</u> unless it "opts out" and elects to defer the tax payment until the asset is actually sold.

If the tax is paid up front, the cost base is simply reset. End of story.

If the fund elects to defer the payment of tax until the asset is actually sold, however, the fund must carry forward this notional $40,000 amount and include it in a future tax return. For the remainder of this example, we have assumed that the fund will elect to defer the payment of tax until the asset is sold.

A few years on, the asset is sold

In June 2020, the fund sells the asset for $4m, realising a capital gain of $1m (from the reset cost base of $3m).

The actuarial % for 2019/20 is 40%. (The pension balance has fallen and new contributions have been added to the accumulation account.)

The fund applies the 1/3rd discount to the $1m capital gain (on the basis that the asset has been held for longer than 12 months), leaving a net capital gain of $666,667.

The actuarial % (40%) is then applied to this discounted amount resulting in a taxable capital gain of $400,000 (ie, 40% x $666,667 = $266,677 is exempt from tax).

This is where the deferred gain of $40,000 re-emerges. It must be added to the taxable capital gain of $400,000 realised upon the sale of the asset in 2019/20. The fund would therefore include $440,000 in its assessable income in 2019/20, and tax would be paid on this combined amount at that time.

For how long can the notional gain amount be carried forward?

Indefinitely. While the draft legislation provided that the CGT relief under the proportionate method (not the segregated method) would only be available if the asset was sold within 10 years of 1 July 2017, this was removed in the legislation tabled in Parliament.

What opportunities and risks does the proportionate method raise?

The proportionate method raises a number of interesting strategic opportunities and issues:

- will CGT relief always be beneficial? Not necessarily. In the example provided earlier, the actuarial % during 2016/17 was 66.67% so the fund was subject to tax on 33.33% of its investment income that year. While the amount might be discounted if the asset had been held for longer than 12 months before being notionally sold on 30 June 2017, broadly speaking 1/3rd of the gain was caught up in the tax system. What if the fund had eventually moved to 100% pension phase by the time the asset was sold? (Perhaps Cathy cashed out the remainder of her accumulation account and Andrew converted his balance to a pension). If the asset was sold at that time, the capital gain would normally be completely exempt from tax. However, if the fund had elected to take up the CGT relief described earlier, tax would still be payable on the notional $40,000 amount carried forward. This is **not adjusted** for the fact that the actuarial % has increased since 2016/17;
- while it might feel attractive to lock in the CGT relief for funds providing transition to retirement pensions – given that these lose the tax exemption on investment income next year – remember that a TRIS will eventually become a "full" account-based pension one day (at age 65, at the latest). A few years where any gains are taxable (ie, not exempt from tax) will only matter if the asset is actually sold then. If it's not sold until the pension becomes a full account-based pension, the fund will be generating tax exempt investment income anyway; and
- there are particular issues to consider for those with very large transition to retirement pensions. They may be particularly incentivised to take advantage of the CGT relief on 30 June 2017 (when the tax exempt actuarial % may be quite high, therefore producing a low notional gain amount that will be taxable at some point) as, in the long term (when they retire / turn 65 etc), they will be subject to the $1.6m pension cap and perhaps constrained by a relatively low tax exempt actuarial % at that time.

Segregating assets post 1 July 2017

The introduction of the transfer balance cap will mean that some individuals will be required to reduce the value of their pension accounts to $1.6m. It is expected that most will rollback some or all of their excess to accumulation phase.

In funds where there are members in both pension and accumulation phase, there is a risk that funds that use the "segregated" method to determine the tax exemption on the fund's investment income would cycle assets between the segregated pools in order to avoid capital gains tax (although note that the general anti-avoidance provisions (Part IVA) would likely apply to such transactions).

In order to prevent this, the legislation would prevent SMSFs (and also small APRA funds) from segregating assets (either segregated pension assets, or segregated accumulation assets) if:

- at any time during the income year, there is at least one pension balance in the SMSF / SAF; and
- just before the start of the income year
  - a person has a total superannuation balance (<u>across all of their super funds</u>) that exceeds $1.6m [2] ; and
  - that person is receiving a pension (whether or not the pension is paid from the SMSF / SAF.

Importantly, note that it will not be necessary for a person with an interest in the SMSF / SAF to be receiving a

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[2] an individual's 'total superannuation balances' at a particular 30 June will be (very broadly):

- the aggregate of the market values of any accumulation, TRIS balances and / or other 'account based' style pensions (eg, account based, allocated, market linked pensions); plus
- the fixed value of any amounts assessed against the individual's personal transfer balance cap in relation to any defined benefit pension; less
- the amount of any personal injury or structured settlement contributions contained in the pension and accumulation balance; plus
- the amount of any rollovers that have been paid from one fund prior to that 30 June, that have yet to be received by a subsequent fund by that 30 June (ie, rollovers 'in transit').

pension from that fund. The SMSF / SAF could be excluded from using the segregated assets method just because one member has more than $1.6m in total in super "somewhere" and they are receiving a pension from any of those funds.

Also, note that this inability to use the segregated method would not apply in cases where the 'pensioner' has total superannuation balances (across all funds) of $1.6m or less.

In cases where the SMSF / SAF is not eligible to use the segregated method to calculate its exempt income, the fund will still be entitled to a tax exemption on its investment income using the actuarial certificate (ie, proportionate) method.

Consider the following example.

On 30 June 2017 Jenny has a total superannuation balance of $2.1m in pension phase, with a $1.6m account-based pension in an SMSF and a $500,000 account-based pension with ABC retail superannuation fund.

On 1 July 2017 she rolls over $500,000 from her SMSF into a new SMSF (SMSF 2) as an accumulation account.

As Jenny has a total superannuation balance exceeding $1.6m on 30 June 2017, neither of the SMSFs she is a member of are able to calculate exempt income using the segregated method and must use the actuarial certificate (ie, proportionate) method for 2017/18. The retail superannuation fund is not affected and can use either method to calculate exempt investment income.

If there are other members of either of Jenny's SMSFs, the segregated method can't be used for their balances either. This is something set at a fund level rather than member by member.

We expect some interesting strategies to emerge here – perhaps using more than one SMSF for those who definitely wish to keep their assets separate and some challenges for those who might be prohibited from segregating for tax purposes but continue to maintain separate investment portfolios for two different members or member accounts within the same SMSF.

Conclusion

In our view, the CGT Relief rules are among the most complex components of the current superannuation changes and create the greatest potential risk for those advising clients in the lead up to 1 July 2017. They are also an area of the legislation that was materially modified between the first round (Exposure Draft) and the version presented to Parliament on 9 November. We expect that Treasury is not quite done yet and that we may see further amendment but the principles seem clear – the challenge will be deciding which clients should vs should not take advantage of the ability to elect to obtain CGT relief and on which assets.

The prohibition on segregation from 1 July 2017 is – in our view – an overreaction to a risk that hadn't actually emerged yet. It is conceptually simple but will be administratively challenging – for the first time, the way in which one member of an SMSF can act (ie, whether or not they can segregate their pension assets) will be influenced by the superannuation balance of another member – even if most of that balance is actually in another fund entirely.

Note that this newsletter is current as at 20 November 2016. The situation is very fluid just now – the last few weeks have seen updated legislation presented in Parliament only a few short weeks after the exposure draft was released for consultation. We may well see further changes before it is passed. Watch this space!

We are currently running half day workshops to explore the strategies presented by all the latest changes. Anyone who is serious about advising, administering or auditing SMSFs must attend – see our website for details.

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