#135 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 for anyone with a special kind of pension, ie:**

- **<u>defined benefit</u> lifetime, or life expectancy, pensions; and**
- **<u>market linked</u> ("term allocated") pensions**

**there are even more issues to think about when it comes to this cap.**

**Perhaps most importantly, these pensions will affect what happens in the SMSF even where they are provided by a completely separate superannuation fund!**

## Introduction

The new $1.6m pension cap is often described in terms of its impact on "traditional" pensions such as account-based pensions. However, it relates to *all* pensions [1] including lifetime, market linked and life expectancy pensions whether they are paid from SMSFs, corporate super schemes or even Government schemes.

But these special pensions raise an interesting challenge in that they can't necessarily be treated in exactly the way outlined in Heffron SuperNews Edition #133 for account-based pensions. This is because that treatment revolved around commuting (including rolling back to accumulation) amounts over and above the individual's pension cap. Some of these special pensions cannot be commuted.

To ensure that recipients of these pensions nonetheless experience a similar degree of constraint around their ability to take advantage of the superannuation tax concessions, there are *special rules* for assessing these pensions against the $1.6m pension cap. The net effect of these special rules would appear to force recipients of these pensions to:

- Roll back / commute pensions to the extent they can (eg, if they have other traditional account-based pensions as well and it is the combined value of all their pensions which takes them above $1.6m); and
- Potentially pay additional taxes **on the pension payments themselves**.

But … in new draft legislation released just before Christmas, the Government introduced new super regulations to allow **these special pensions to be commuted** (subject to their own governing rules) in order to avoid an *excess* over the pension cap.

At first glance, the ability to commute an excess amount from these previously non-commutable pensions might appear to make the above special rules redundant, but, remember that the new super regulations (assuming they become law) will simply empower a fund to allow a commutation – there will still be plenty of situations where the governing rules for the fund don't allow the commutation or where it's highly undesirable for the member to take advantage of it.

This appears to give recipients some extra choices and decisions to make.

The special rules for these pensions therefore have a significant impact on recipients who are SMSF members regardless of whether or not the special pension is actually provided from the SMSF.

## Which pensions are governed by the special rules?

The Tax Act describes these special pensions as "capped defined benefit superannuation income streams". The term is unhelpful because it includes:

- All complying lifetime pensions (provided under SIS r 1.06(2));
- Complying life expectancy pensions (provided under SIS r 1.06(7)); and
- Market linked pensions (or term allocated pensions, TAPS) which are provided under SIS r 1.06(8).

The final pension is not actually a defined benefit pension in the traditional sense (ie, one where the trustee promises a particular income stream over time), it is an income stream where the annual payment simply depends on the account balance at the start of the year and a particular payment factor. It is simply grouped with the other two pensions for the purposes of the $1.6m pension cap because it does not allow commutations to be cashed out or rolled back to accumulation phase.

The definition also *excludes* one final group of pensions that are traditionally called defined benefit pensions – those provided under SIS r 1.06(6). These are often described as flexi pensions, or commutable pensions. They are defined benefits in the conventional sense in that

[1] Where the pension is paid solely from unpreserved money (ie, all pensions except TRIS')

they involve a promised benefit that does not depend on the account balance set aside to support it. However, these pensions can be commuted at any time and the commutation value:

- converted to an account-based pension;
- rolled back to accumulation phase;
- cashed out as a lump sum; or
- some combination of the above.

(There are some very significant complications and disadvantages to the member when they take this action but nonetheless it can be done.)

Hence this final group of pensions are not regarded as "capped defined benefit superannuation income streams" for the purposes of the $1.6m pension cap. This means they will be treated exactly like an account-based pension – if they cause the member to exceed the pension cap it may be necessary to commute the pension etc.

## How are these special pensions valued when it comes to checking them against the $1.6m pension cap?

Unlike "normal" pensions, the value of a complying lifetime pension, for example, is **not** simply a "member account" or the amount set aside to provide it. In fact, in a Government or corporate super scheme there will be no concept of a "member account" from which this pension is paid. It will simply be part of a suite of promises the fund has made to various members and ex-members and payments will be made from a large pool of assets or (in the case of some Government schemes) current Government revenue.

The "Special Value" of these capped defined benefit pensions is therefore worked out using a *formula*. The specific formula depends on the type of pension.

**Valuing pensions that have a fixed "term" (payment period)**

This would include life expectancy pensions and market linked pensions.

These are valued as follows:

| |
|---|
| Annual Entitlement x |
| Number of years remaining in the term (rounded up to the next whole number) |

In other words, consider a market linked pension that started on 1 January 2007 with a term of 20 years. At 30 June 2017 (the date on which the pension will need to be valued as part of the changeover to the new pension cap rules) the term remaining will be 9.5 years. For the purposes of this formula, the remaining term will be rounded up to 10 years.

If the annual entitlement is $50,000, the value placed on that pension for the purposes of the pension cap will be $500,000.

This is the case even though market linked pensions actually DO have an account balance. In other words, the account balance is ignored and the formula is used instead.

The annual entitlement is based on the first payment made in 2017/18 (effectively it is "pro-rated up" to convert – say – a monthly payment made in July to an annualised amount). Given that market linked pensions don't have fixed annual payments, rather they have *flexible* payment amounts, it is not entirely clear how this will actually work in practice. Unless the ATO releases further guidance or changes are made to the legislation, it would appear that members will have considerable flexibility to "nominate" that the first payment they take in 2017/18 is targeting the lowest possible annual entitlement.

The situation is more obvious for life expectancy pensions as these at least have a *fixed* annual payment each year.

**Valuing lifetime pensions**

The formula for these pensions is:

| |
|---|
| 16 x Annual Entitlement |

(with the same rules around the calculation of the Annual Entitlement as above for life expectancy and market linked pensions).

Importantly this same "valuation factor of 16" applies regardless of:

- The age of the pensioner;
- Whether or not the pension is indexed over time; and
- Whether the pension is reversionary to a spouse.

Some very rough rules of thumb are:

- the factor of 16 is actuarially "right" (ie, places a reasonable value on the pension) if the recipient is say 60-65 and the pension is indexed or perhaps reversionary to a younger spouse; but
- it will generally ***overvalue*** the pension for someone much older. This means it will potentially ***use up more of the individual's $1.6m pension cap*** than it should.

## How is this Special Value then fed into the assessment against the $1.6m pension cap?

Whenever an individual has a capped defined benefit income stream, they will

have a separate *special balance* [2] that relates *solely* to these pensions.

This special balance runs in conjunction with the balance that counts towards their *normal* pension cap. Only the Special Value of capped defined benefit pensions counts towards (or is debited / reversed from) this special balance.

*No upper limit* applies to the amount of this special balance, rather it will be used in conjunction with the *normal* pension cap to determine the extent to which an individual can *also hold commutable (eg, account-based) pensions.*

Consider the following example. On 30 June 2017, Jane holds an account-based pension with a balance of $500,000. On 1 July 2017, this amount will count towards her pension cap ($1.6m).

On 1 August 2017, Jane starts to receive a complying lifetime pension (ie, a capped defined benefit pension) of $125,000 pa.

An amount of $2m (ie, the Special Value of 16 x $125,000) will count towards both her normal pension cap *and* her special balance.

At this time, Jane would have a balance of $2.5m counting towards her normal pension cap (ie, $500,000 from the account-based pension plus $2m from the complying lifetime pension).

In addition, Jane would have a separate special balance of $2m in relation to just her capped defined benefit pension.

*Ordinarily*, Jane would exceed her normal pension cap by $900,000 (ie, $2.5m - $1.6m) and she would be required to remove the excess (and an amount of notional earnings) from pension phase.

Obviously that's impractical if it forces her to commute a pension that she can't commute! For that reason, the rules incorporate some extra steps.

## What happens when an individual exceeds their pension cap because of a capped defined benefit pension?

Whenever a capped defined benefit pension is involved the **"excess"** for the purposes of the pension cap is calculated as the ***lesser*** of the amount that exceeds:

- the normal pension cap; or
- the separate special balance that represents a running total of the value of just capped defined benefit pensions.

In Jane's case, she exceeds:

- her normal pension cap by $900,000 (ie, $2.5m - $1.6m); and
- her separate special balance by $500,000 (ie, $2.5m less her special balance of $2m that relates just to her capped defined benefit pension).

As the *lesser* of these amounts is $500,000, Jane's excess would therefore be $500,000, *not* $900,000.

**What if the governing rules of the fund *don't* allow for the capped defined benefit pension to be commuted to remove the excess? Or they do, but the member chooses not to commute the excess?**

Let's assume for the moment that the particular rules of Jane's super scheme mean that she *cannot* commute her complying lifetime pension. She will be required to:

- firstly, commute (ie, stop) her account-based pension, either in full or in part, in order to remove the excess (together with the fixed amount of notional earnings that applies to the excess); and
- in cases where an excess remains after *all* account-based pensions have been *fully* commuted, she will *no longer* be considered to have an amount in excess of her pension cap. A debit (or reversal) of the amount of the excess will be applied to her *pension* cap by the Commissioner. The amount of this debit will be whatever amount is needed to bring the amount standing to the credit of her pension cap back down to $1.6m.

  This is so that Jane doesn't fall into any of the requirements to make further commutations from her pensions (since she can't do this – her only remaining income stream is not commutable).

No such debit (or reversal) will, however, apply to the amount standing in her special balance (ie, the balance that relates just to her complying lifetime pension – her capped defined benefit pension). This means the Commissioner is effectively still tracking the fact that Jane has exceeded the limits.

Like account-based pensions, there are rules that "reverse" amounts that have

[2] This "special balance" is called the "capped defined benefit balance".

been counted towards the special balance and the normal pension cap if Jane commutes (in part or in full) her capped defined benefit pension. In Jane's case (where the complying lifetime pension is not normally commutable) this might apply if the fund providing it was closed and her entitlement was moved to another fund.

**What if the capped defined benefit pension *could* be commuted?**

As mentioned earlier, new draft super regulations were released for consultation in December 2016. If these become law, they will add extra circumstances under which capped defined benefit pensions *can* be commuted. Commutations will be allowed where they are made to deal with an actual or expected *excess* over the pension cap.

Remember, the rules of the specific fund providing the pension will be important here – they may prohibit the pension from being commuted in which case the treatment will be exactly as outlined earlier for Jane.

However, it's likely to be possible if the pension is provided from an SMSF – even if the original rules don't permit a commutation under this circumstance, the trustee will often have the flexibility to change the rules, removing that prohibition and aligning the rules with the prevailing legislation.

Assuming the proposed regulations become law, a member in Jane's position *may* have some additional *options* to consider:

- Rolling back enough of her complying lifetime pension such that she could *leave her account-based pension in place.* (If she commuted 45% of her complying lifetime pension she would be left with an annual entitlement of $68,750 pa. The formula value for pension cap purposes of this pension is $1.1m (ie, 16 x $68,750), taking her combined entitlements up to her $1.6m cap ($500,000 account-based pension plus $1.1m complying lifetime pension); or

- Roll back a combination of account-based and complying lifetime pensions – again, such that the combined value was $1.6m.

Importantly, under (the new draft) superannuation regulations, any commutation value Jane receives for the partial roll back of her complying lifetime pension *could* be kept in accumulation phase, paid out of super etc. It would *not* need to be converted to another restrictive pension as is currently the case.

**This is profound.** Where the complying lifetime (or even life expectancy or market linked) pension is held within an SMSF it *might* allow people who have been constrained by highly inflexible pensions for over 10 years to escape that environment. In fact, someone with a larger account-based pension (say $1.6m) could potentially roll back their entire capped defined benefit pension to accumulation phase!

We are unclear at this stage whether the Government meant to provide such significant flexibility or whether this new draft regulation (introduced several months after the major changes to the Tax Act) will actually become law. We would therefore counsel against action right now.

If the regulation *does* becomes law, however, it creates some significant opportunities.

In fact, the individuals **most likely** to take advantage of this opportunity are those with the restrictive pensions in their SMSF rather than a corporate or government fund. This is because external funds are typically structured with very low commutation rates. In other words, an individual might receive quite a low lump sum (the commutation value that can be rolled back to accumulation phase or cashed out) given the reduction in their pension income. This often provides an incentive to leave the pension running.

In contrast, where the pension is provided from an SMSF the same wealth remains within the fund either way.

In deciding whether or not to use this opportunity roll back their capped defined benefit income stream, each individual will weigh up a number of competing factors:

*Maximising* the roll back of these pensions:

- allows the recipient to leave more of their account-based pension(s) in place. In the extreme, someone with a very large capped defined benefit pension (with a special value of over $1.6m) who chooses not to roll it back at all will not be able to have any account-based pensions at all;

- increases flexibility which can be valuable in (for example) allowing the individual to cash out their super during their lifetime; and

- helps reduce the income from these pensions which (as explained below) is potentially subject to tax from 1 July 2017.

On the other hand, minimising the roll back of these pensions might allow an individual to have a much larger balance in pension phase than $1.6m.

This latter point is perhaps best understood using an example.

**Example**. Imagine an individual with a very large super balance - $3m in an account-based pension and $6m in a market linked pension.

The market linked pension alone would have a Special Value (for pension cap purposes) of more than $1.6m.

However, as long as the member completely rolls back their account-based pension they will be deemed to have no excess at all. This would allow them to keep 66% of their fund in pension phase – receiving a tax exemption on 66% of the fund's income.

If instead they roll back their entire market linked pension and $1.4m of their account based pension only $1.6m (around 18% of the fund) would remain in pension phase.

If this regulation does become law, the best choice won't necessarily be obvious!

There are also some obvious administrative challenges to address. For instance, in the example above (a $6m market linked pension and $3m account-based pension) the initial excess is capped at only $3m. This is the lesser of:

- Total Amounts checked against the pension cap (the Special Value of the market linked pension + the account based pension)

  less $1.6m.

  Let's ignore the complexity described earlier for a moment and imagine that the Special Value of the market linked pension is the same as its account balance ($6m).

  This excess would therefore be $7.4m ($9m less $1.6m); and

- $9m - $6m = $3m (total amounts checked against the pension cap less the Special Value of the capped defined benefit income stream).

If the member responded by rolling back the expected $3m excess <u>but chose to do so from their market linked pension</u>, their excess would still be $3m. This is because even after the roll back the excess would still be calculated as the lesser of:

- $6m less $1.6m = $4.4m (total amounts checked against the pension cap less the limit of $1.6m); and

- $6m - $3m = $3m (total amounts checked against the pension cap less the Special Value of the capped defined benefit income streams).

Arguably to achieve the result outlined in the example above, the member would actually need to quickly carry out multiple roll backs of the market linked pension and then a final $1.4m from the account-based pension.

In fact the process would be even more complex because remember the Special Value of the market linked pension would NOT be the same as its account balance. Hence reducing the Special Value of the market linked pension by (say) $3m is not as simple as taking a partial commutation of $3m.

## Special treatment for pension payments

The above processes essentially ensure:

- anyone with an excess based on their "capped defined benefit pension" who doesn't roll any of this pension back to accumulation or cash it out will be forced to roll back / cash out their account-based pensions in full to remove any excess; and

- if even rolling back / cashing out these account-based pensions in full does not remove the excess, they will effectively be excused from the excess pension cap regime.

The latter point means one final step is required to ensure equity between members with these pensions and others.

Under *current* tax law, the tax treatment of a pension payment from super depends solely on:

- the age of the pensioner (or a deceased pensioner in the case of pension payments that are paid to someone as a result of someone else's death); and

- the underlying tax components of the pension payments, ie the tax free and taxable components of the payment.

In *some* cases, the taxable component is subdivided into two elements : an "untaxed element" and a "taxed element" – this subdivision of pension payments only occurs in cases where a pension is paid from an "unfunded" superannuation fund such as a government superannuation fund.

The tax free component of a pension payment is always tax free (ie, it is non-assessable non-exempt income), regardless of the age of the pensioner (or of a deceased pensioner).

The underlying elements of the taxable component are taxed at different (concessional) rates as outlined in the table below.

Importantly, there has historically been no limit to the *amount* of pension income that can receive the concessional tax treatment.

Under the new tax regime, this will change for some individuals.

**New defined benefit income cap & its implications**

Under the *new* tax regime from 1 July 2017, some individuals in receipt of a capped defined benefit pension will be subject to a limit on the amount of concessionally taxed payments made from these pensions.

The limit for a financial year will be:

| The general pension cap [3] / 16 |
|---|

Ie, $100,000 pa for 2017/18 (with some special adjustments for people who turn 60 during the year etc, but these refinements have been ignored here).

If the individual is affected by this change and their payment exceeds the limit, additional taxes will apply to the excess amount. For example, someone receiving $120,000 pa from a capped defined benefit pension who is affected by this change would pay some extra tax on the $20,000 over their $100,000 pa limit.

*Who is affected?*

The change will only affect people eligible for the "best" tax concessions on pension payments. This includes those who are:

- 60 or over; or
- Under 60 and receiving a pension because of someone else's death and the deceased was over 60 when they died.

Importantly it *doesn't* include those under 60 who are receiving their own capped defined benefit income stream (rather than a death benefit pension). These will continue to be taxed in the "normal" way.

For those affected by the change the treatment is as shown in the table below:

| | **2016/17 "normal" treatment (ie ignoring any defined benefit income cap)** | **New treatment from 1 July 2017 (ie allowing for the defined benefit income cap where applicable)** |
|---|---|---|
| Tax free component | Tax free | Tax free up to the defined benefit income cap. 50% of the pension income over this amount is taxed at normal marginal rates (no offset) |
| Taxable component (taxed source) | Tax free | |
| Taxable component (untaxed source) | Taxed at marginal rates less a 10% tax offset | Taxed at normal marginal rates less a 10% offset ***but*** the 10% offset is limited to 10% of the pension payment to the extent that it falls within the defined benefit income cap. |

*A simple example*

John is 70 and receiving a $140,000 pa defined benefit pension which is paid from his SMSF (it does not include any amount from an "untaxed source").

The defined benefit income cap is $100,000 and so 50% of the excess over this amount (50% x $40,000 = $20,000) is added to John's assessable income and taxed accordingly. There are no tax offsets.

The same treatment applies even if John's entire pension consists of a tax free component.

*A pension from an untaxed source*

What if John received the same pension from an unfunded Government scheme?

Under this scenario the pension might consist entirely of a taxable component from an untaxed source. This would be taxed as follows:

- $140,000 would be included in his assessable income and taxed at marginal rates; however
- He would be entitled to a 10% offset capped at 10% of $100,000 ($10,000) rather than 10% of the whole pension of $140,000.

## The $1.6m pension cap and pension payments in excess of the income cap

The driver behind this tax treatment of certain pension payments is to introduce

[3] ie, $1.6m for 2017/18

some equality between "special" capped defined benefit pension recipients and those with "normal" pensions who are limited to $1.6m counting towards their pension cap.

But the legislation does not actually directly link the two.

For example the $100,000 pa income cap makes sense in the context of a lifetime pension where the amount that counts towards the pension cap is calculated as 16 x the annual entitlement. However, it bears no relationship to the treatment of life expectancy and market linked pensions. It is entirely possible, for example, to find that an individual:

- has a "Special Value" of *more than* $1.6m (eg, a market linked pension with a 20 year term and an annual payment of $100,000 would result in $2m being counted for the purposes of their pension cap) but no detrimental tax treatment on the pension payments (since they do not exceed the $100,000 pa income cap); or
- has a "Special Value" which is less than $1.6m despite having income of more than $100,000 pa (eg, a 5 year market linked pension with an annual entitlement of $150,000). This individual would effectively lose tax concessions on the "excess" $50,000 pension payment even though it might be his only superannuation and he clearly has no excess when it comes to the $1.6m pension cap.

Note also that the special extra taxes only apply to pension payments from a capped defined benefit pension. If the member is ***also*** receiving payments from an account-based pension, these are completely unaffected. (This is possible under the example earlier where a 5 year market linked pension provided a $150,000 pa pension payment. Its Special Value would be sufficient to allow the member to have an account-based pension as well without breaching the $1.6m pension cap.)

## Conclusion

Complying lifetime, life expectancy pensions and market linked pensions are not particularly common these days but as usual they present particular issues! A vital consideration with this round of changes will be the way in which a capped defined benefit income stream from another fund will affect the optimal choices in the SMSF.

We will also be watching with interest to see whether the final Regulations provide flexibility – for the first time ever – to roll these pensions back to accumulation phase or even cash them out.

We are re-running our half day workshops to explore the strategies presented by all the latest changes in February / March 2017. Anyone who is serious about advising, administering or auditing SMSFs must attend – see our website for details.