#136 Heffron SuperNews

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Heffron SMSF Solutions

Problem solved

If there is one issue that has created a stir around the new super legislation, it's the complexity on CGT relief. It's certainly unnecessarily restrictive and therefore complicated. In this edition of Heffron SuperNews, we work through a case study for one particular fund by way of an example.

Remind me - what is the CGT relief?

The law recognises that superannuation funds providing pensions currently claim a valuable tax concession. The fund pays no income tax on rent, interest, dividends, capital gains etc on income it earns on the assets it is investing to support pensions. If a given asset is supporting a mixture of pension and non pension (accumulation) benefits for its members, some of this income is tax exempt.

For some people, this concession will be wound back considerably when the new rules take effect from 1 July 2017:

- Transition to retirement income streams will no longer entitle a fund to this benefit; and
- "Full" pensions (ie not transition to retirement income streams) will be capped at a new limit of $1.6m at 1 July 2017. For people with higher balances who remove the excess from their pension but leave it in their super fund, this will mean that a smaller proportion of their fund will be providing a pension and so less of their investment income will be exempt from tax.

This is a particularly big deal for those with assets that have grown over time and are likely to result in a large capital gain when sold in the future.

The way the law works is that the amount of the gain that is taxed depends only on how much of the fund was in pension phase when the asset is actually sold. Currently this means that even if most of the capital gain was built up before any pensions started, the fund will benefit from the tax break when it sells the asset in pension phase. But equally, if they happen to stop some or all of the pension(s) and sell the asset when a much smaller proportion of the fund is supporting pensions, more of the capital gain will be taxable even if it mostly built up during years when the fund was entirely in pension phase.

It is this latter point that will affect funds as a result of the changes. Had nothing changed, many funds might have found that none (or at least only a small part) of their capital gains were taxed. Now that the rules are changing from 1 July 2017, a lot or even all of these gains might be taxed because a lower proportion of the fund will be in pension phase.

To ease the transition the Government has provided the opportunity for some relief. 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 ***notionally*** sell certain assets during the period 9 November 2016[1] – 30 June 2017 and buy them back immediately at the same price. No actual sale takes place, it's a purely notional event. However the law specifically defines this as triggering the normal tax rules for capital gains tax during that period. It means that:

- some funds would trigger a tax bill (if they are only partly in pension phase and so still paying tax on some of their income) – but there are rules allowing this to be deferred until the asset is really sold; but
- when the asset is sold in the future, its purchase price (referred to as the "cost base" in tax law) will be based on its value on the day this notional sale and reacquisition happened, not when it was originally bought. This is the crux of the relief – it is often referred to as "re-setting the cost base".

In theory the net effect of these two points is that when the asset is eventually sold, it will pay:

- exactly the same amount of tax on the "pre re-set date" capital gains as if the old rules had applied and the fund had remained exactly as it was pre 1 July 2017; and
- tax on capital gains built up after the re-set date on the new rules.

For some funds the relief will be hugely valuable – as the case study explains.

[1] This is the date the relevant legislation was presented to Parliament. It's a very important date for the purposes of the CGT relief.

Case Study Facts

Barry (63) and Anne (61) are retired and all their super is currently held in their SMSF. Their balances are $2m and $1.2m respectively. They are currently entirely in pension phase and have been for some time. Both intend to make non-concessional contributions this year but haven't done so yet.

Obviously Barry (at least) will need to make adjustments to his pension account to comply with the $1.6m pension transfer balance cap on or before 30 June 2017.

In the future, their fund is likely to have a mixture of pension and non pension (accumulation) accounts and therefore will have to pay tax on some of its income.

Their investments include a property and a portfolio of listed shares. So, they may find that in many years the franking credits on their shares are still enough to completely negate their fund's tax bill. However, this doesn't change the fact that they will be affected – at best their refund will be lower than it would have been if the rules hadn't changed.

So what's their position in relation to the CGT relief?

Two methods – which one applies?

The law provides two methods for accessing the relief. These are known as the "segregated" and "proportionate" methods.

Each one has specific eligibility criteria and they apply to each asset individually. In theory it is entirely possible for a single fund to have some assets on which they claim the relief under the proportionate method and some where they use the segregated method.

The fund's trustee(s) have a choice as to whether they opt-in for the relief but not which method is used. That is dictated solely by the fund's circumstances (i.e. how the fund was operating) at 9 November 2016.

It is also possible for a fund to compromise its ability to opt-in for the relief by action taken by the trustee now. Starting or stopping pensions and accepting contributions at the wrong time this year can be disastrous. This is why understanding the rules is so important.

So which method applies for Barry and Anne?

The key in their case is that their fund was entirely in pension phase on 9 November 2016. This means all of their assets were "segregated" at that time. (The tax law uses the term segregated to describe assets that are set aside for the sole purpose of providing pension benefits.)

The ***only*** method potentially available to them is the segregated method and so we have only discussed this method in the case study.

> It is very important to note that had their fund looked different at 9 November 2016 the options, strategies and traps raised in this case study could have been entirely different.

Segregated method for Barry and Anne – what's available?

Since the segregated method applies to Barry and Anne's fund, the relief works like this:

- it only applies to assets the fund held at 9 November 2016 – so it won't apply to shares they have bought since;
- it only applies to assets they still hold at 1 July 2017 (which makes sense – they don't need the relief this year, their gains are already tax exempt);
- it only applies to assets that **stop being segregated to provide pensions** before 1 July 2017;
- as mentioned earlier, the assets eligible for the relief will be treated as if they were sold and repurchased on a particular date. Any capital gains built up at that time will be ignored (not taxed) as will any losses;
- the particular date on which the cost base of these assets is re-set is the date on which they stop being segregated; and
- they have to "opt in" (by completing forms for the ATO) to the relief before their fund's 2016/17 tax return is due (we expect this process will form part of the tax return itself). They can choose whether to opt in on an asset by asset basis – just because they decide to opt in for (say) their property doesn't mean they have to do the same for all of their shares.

How do assets stop being segregated?

Barry and Anne probably don't feel they've done anything to be "segregated" – it just happened because their fund moved entirely to pension phase.

It will be undone, then, if their fund stops being entirely in pension phase. This might happen if:

- they make contributions; or
- either one of them stops part of their pension and moves those amounts back to accumulation phase.

Both of these events are likely in their case – they intend to make new contributions and Barry will be "rolling back" some of his pension to accumulation phase before 1 July 2017 to make sure he's under the $1.6m pension limit. We've assumed he will keep this money in super (in a new "accumulation account") rather than cash it out entirely.

This is good on one hand – it will trigger eligibility for the relief. But there's

another layer of complexity in that they will trigger the relief on the earliest date one of those events occurs. If they made a contribution in January, the cost base was re-set back in January whether they knew it or not!

Is there anything they can do to control the timing?

There are several options to consider here:

1. They have complete control over when Barry adjusts his pension account. Most people will do this on 30 June 2017 as a matter of course to minimise the time their fund has additional amounts in accumulation phase. In Barry and Anne's case this also allows them to delay the date on which their fund re-sets its cost base unless another event triggers it earlier;
2. They can defer the contributions until the last minute, late in June – the cost base will then not be re-set until then.

What if they want to make the contributions earlier?

This doesn't matter if Barry and Anne are happy to re-set the cost base of the assets for which they wish to claim the CGT relief when they make the contributions. But if they want to delay this for as long as possible, there are a few options:

1. They could make the contributions earlier but into a new, separate bank account (still owned by their SMSF) which is exclusively for these new contributions. This is one way of keeping the non pension money quite separate from the pension investments. Doing so would mean the fund remained segregated and hence nothing would trigger the cost base re-set. This is true even though it now includes a combination of pension and non pension accounts.
2. A variation on the above – the contribution could be made to an existing bank account but the trustee could elect ***in advance*** that the bank account is to be notionally divided up into a "pension sub account" and an "accumulation sub account". From a tax perspective, this gives the same outcome as using a completely separate account (as long as neither sub account ever subsidises the other).

In both cases it would be important to remember that:

- if the cash from the contribution(s) was later used to purchase investments and these were not kept separate from the pension investments, the fund would stop being segregated – triggering the cost base re-set; and
- eventually they would need to make sure they took action later in the year – such as combining their bank accounts, rolling back part of their pension account etc to stop being segregated before 30 June 2017 as they actually want to trigger the cost base re-set at some point.

Bear in mind that it's only important to keep pension and non pension (accumulation) investments apart in order to segregate a fund. If Barry and Anne immediately commenced pensions with these new contributions, they could go back to running the fund as a single investment portfolio as soon as that happened. The period through which they have to manage two bank accounts (or two sub accounts) might therefore be very brief.

Is there anything Barry and Anne really want to avoid?

Apart from triggering the cost base re-set too early, there are two outcomes Barry and Anne would want to avoid:

- not triggering it at all. Since the relief is only available for assets that stop being segregated, they need to do *something* at some point during the year. As mentioned earlier this could be as simple as rolling back part of Barry's pension
- remaining segregated even after rolling back part of Barry's pension. This might happen if, for example, they have always run their assets as completely separate portfolios (one for Barry, one for Anne). If this is the case, taking action on Barry's pension alone might mean that Anne's remains fully segregated. This would mean that there was no trigger to re-set the cost base on her assets (and therefore no CGT relief).

  It could also happen if, when rolling back part of Barry's pension account, they matched that event with a specific movement of assets to a new "accumulation" pool (eg a separate broking account for shares underpinning the accumulation account) and therefore only the assets supporting the rolled back part of Barry's pension stopped being segregated pension assets. Under those circumstances the relief would only be available on these non pension assets, not the entire fund.

And then what would the relief actually mean for Barry and Anne's fund?

As mentioned above they can choose the assets where they will opt into the relief.

They will probably choose to opt in to the relief for all of their fund's asset except those where:

- they are worth less than the fund bought them for – ie, they are in a loss position. There is no real value to Barry and Anne in making the cost base lower;

- they have only made a small gain before the cost base is re-set, the fund is likely to sell them in the next 12 months and the gain during the next 12 months is expected to be large. We expect this will be relatively unusual. However, the reason it is an important consideration is that re-setting the cost base also re-sets the purchase date for capital gains tax purposes. The way capital gains tax works is that only part of the gain (2/3rds in the case of a superannuation fund) is taxed if the asset has been held for more than 12 months before it is sold.

  Consider the following scenario.

  The fund bought an asset for $100,000 on 1 July 2016. Its cost base is re-set to $105,000 on 30 June 2017. It is then sold for $120,000 on 1 December 2017.

  If the fund hadn't opted into the CGT relief for this asset it would have been held for more than 12 months by the time it was sold and the fund would pay tax on :

  2/3 x ($120,000 - $100,000) = $13,333

  (reduced to the extent that the fund has capital losses or is providing pensions in 2017/18)

  If the fund **had** opted in for the CGT relief for this asset, however, it would not have been held for 12 months after 30 June 2017 and so the 2/3rds discount would not apply. The fund would pay tax on the following:

  ($120,000 - $105,000) = $15,000

  (Again, reduced to the extent that the fund has capital losses or is providing pensions at the time.)

As mentioned earlier, the assets on which their fund does claim the relief will be treated as follows:

- the capital gains made as a result of the notional sale and repurchase will be completely ignored – as will any losses;
- the new cost base will be used to work out any future capital gains
- this would be the case even if the fund stopped paying pensions entirely during 2017/18 and all the fund's assets were eventually sold while the fund was entirely in accumulation phase.

Conclusion

The CGT relief provisions are undoubtedly the most complex of the new regime.

This is one very specific case study and even this simple case had some interesting issues. The variables surrounding the clients who must claim it on the proportionate method are actually even more quirky!

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.