#140 Heffron SuperNews

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Heffron SMSF Solutions

Problem solved

In this edition, we use a case study to explore the action being taken for SMSF members and trustees transitioning to the "new world" post 1 July 2017.

Introduction

This year, 1 June is not just the first day of winter. It also starts the final month before the most significant changes to superannuation in 10 years take effect.

For that reason, we have used a case study to explain some of the steps currently being considered by SMSF members who know they need to make changes between now and 1 July 2017.

The facts – Bob and Jane

Bob and Jane are both in pension phase in their SMSF. Bob is 64 (turning 65 in August 2017) and Jane is 63. Their pensions have been in place for several years. They don't need the pension payments to live on – they started the pensions because the tax result seemed too good to be true at the time! (They're not surprised that the changes will reign this in for them.)

Bob is still working. His employer contributes to Bob & Jane's SMSF and these contributions are just accumulating in the Fund in his name rather than paying a pension. His accumulation balance is very small, around $100,000.

Jane retired a while ago.

Bob's pensions are currently transition to retirement pensions and Jane's pensions are retirement phase account-based pensions.

They currently invest their super in three distinct pools – one wrap account for Bob's pensions, a second for Jane's and a third for Bob's accumulation balance.

Their overall superannuation can be summarised as follows:

	Balance	Tax Free %
Bob		
Pension 1	$3.5m	0%
Pension 2	$0.5m	100%
Accumulation	$0.1m	$nil
Total	$4.1m	
Jane		
Pension 1	$0.8m	0%
Pension 2	$0.7m	100%
Total	$1.5m	

None of their pensions are reversionary.

They have three adult, financially independent children. When they die, they want their superannuation to pass firstly to each other and then to their children.

In the past – before they started their pensions – they made some capital losses. Some of these are still being carried forward because any new capital gains they make on the assets supporting their *pension* accounts are ignored (these assets are segregated – they have distinct pools of assets that solely support the pension balances). The amount being carried forward is around $0.3m at 30 June 2016.

Some of the suggestions we have given people like Bob and Jane

Bob's pensions

As Bob has transition to retirement pensions he is not actually affected by the new $1.6m cap on pensions on 1 July 2017. However, the limit will apply as soon as he turns 65 in August 2017.

Arguably Bob could simply leave his transition to retirement pensions in place and then make sure he winds one of them back to $1.6m on his birthday (e.g., take a "partial commutation" on that date and reduce the remaining balance to exactly $1.6m).

However, unless he completely stops and re-starts his pension on his birthday, the minimum he's required to withdraw throughout 2017/18 will be based on his account balances at 1 July 2017, not just the $1.6m that it is reduced to on his birthday. Stopping and re-starting on his birthday can be complicated because it means he must have paid the pension "up to date" first.

For that reason, Bob might instead:

- Leave Pension 2 in place (it is 100% tax free and there are benefits to leaving this quarantined from the rest of his balance – see below);
- Fully commute Pension 1 on 30 June 2017;
- Re-start a pension on his birthday with exactly $1.6m ***less*** the value of Pension 2 at that time; and
- Leave the remainder of his superannuation accumulating in the Fund.

The minimum payment required from his new pension in 2017/18 will be based on the actual starting balance of the pension (around $1.1m) and it will be pro-rated to reflect the fact that it is only in place for roughly 11 months of the year.

Why leave Pension 2 in place?

A key difference between Bob's two pensions is the "Tax Free %". This is the proportion of the pension balance that is considered to be a "tax free component" when it comes to taxing superannuation benefits. It's not relevant for Bob and Jane:

- because they are both over 60 and therefore pay no tax on anything they withdraw from super in any case; and

- they can inherit each other's super without any tax applying.

However, it is highly relevant for their children. They can inherit this pension with no tax whereas they will pay at least 15% (+ Medicare if applicable) on any "taxable" component.

Hence the children are better off if Bob and Jane leave behind super that is largely a "tax free component".

Arguably this is best done by choosing the "100% tax free" pension to be rolled back to accumulation phase.

The chief benefit of doing this is that Bob and Jane aren't compelled to ever take money out of an accumulation account until they die (whereas money must come out of a pension account). In other words, the $500,000 tax free component would remain intact.

However, there are some special benefits to leaving it in a *pension* which override this in Bob's case:

- when a tax-free amount is held in a pension, it grows with the account balance. (Of course, eventually the account balance will fall when the pension drawings get larger as Bob gets older);
- leaving it in the pension means it can remain quite isolated from Bob's taxable super – and therefore should Bob need additional money in the future he can take it from this taxable super without touching the tax-free money; and
- it is easier to pass on to Jane this way (via a reversionary pension – discussed further below) making it more likely that the tax-free money remains in the fund until the very end when Jane dies.

Jane's pensions

Jane's pensions count towards the $1.6m pension limit on 1 July 2017 but their value falls short of the limit at the moment and so no action is required (unless she sees a lot of growth between now and 30 June 2016.)

It might be prudent for her to still minute an intention to roll back any excess over $1.6m at 30 June 2017 even though there is a chance she won't need to do so.

Make pensions reversionary

Bob and Jane's pensions aren't reversionary at the moment which has probably been fine in the past. In future, reversionary pensions will be useful because they allow an individual to inherit a deceased spouse's superannuation with a 12 month deferral of the assessment against their $1.6m pension cap.

The Heffron trust deed allows this to be put in place via a simple trustee resolution rather than requiring the pension to be stopped and re-started (which can often be useful if the pension is grandfathered for the purposes of the income tests that apply to the age pension and the Commonwealth Seniors Health Card).

Review binding death benefit nominations

Different trust deeds will have different rules about whether a reversionary pension overrides a binding death benefit nomination or the other way around. Not only is it important to be clear which applies but it is also important to check that the two are consistent.

There's not much point having a reversionary pension if the binding nomination would override it and currently directs all death benefits to the deceased's Estate!

Or what if they decided that their pensions should revert to each other but accumulation balances should be paid to their Estate? Their binding death benefit nomination would need to reflect that and express the nomination in terms of account balances rather than (say) a percentage of their overall super.

Contributions

They are both under 65 and let's assume they haven't made any non-concessional contributions in the last few years and so aren't in the middle of a "bring forward" period.

They should consider making $540,000 non-concessional contributions one last time. If they don't wish to add new capital to their SMSF, they could at least withdraw some of their taxable super and recontribute it.

At the very least, they could think about:

- withdrawing the maximum possible from Bob's larger pension (10% of his account balance at 1 July 2016); and
- recontributing it for Jane

This is largely aimed at achieving a more even split of their superannuation entitlements.

Neither of them are likely to be allowed to make non-concessional contributions in the future – even Jane will probably exceed the $1.6m limit shortly.

CGT Relief

The Fund is potentially eligible for CGT relief on the "segregated" method (because the pensions were supported by specific pools of assets on 9 November 2016 and nothing has altered that yet.)

There are some traps for Bob and Jane though purely because of these specific pools:

- in Jane's case, she does *not* need to do anything to comply with the new $1.6m pension limit. This means that if her pool of assets remains solely supporting her accounts, there is **no CGT relief available** for any assets in her specific pool. Importantly, this is the case even if

she decides to roll her pensions back to accumulation phase – remember, she's not *required* to do anything and therefore her pool of assets is not eligible for CGT relief.

- this will be a disaster if Jane has large gains built up in these assets because the Fund will be required to operate on a "pooled" basis for *tax* purposes from 1 July 2017 (given its size). This means only a proportion of these gains will be exempt from tax in the future, including any gains built up before 30 June 2017.
- the trustees can, however, act to ensure that they are eligible for CGT relief on all of the "pension" assets (not the assets supporting the accumulation account unfortunately). This would require the trustees to stop operating the specific pools of assets for the various pension accounts and instead combine these into a single group that supports *all* of the pensions. (Note that this doesn't mean they must unwind the separate wraps before 1 July 2017 – see below).

  There are two potential scenarios under which this could happen.

  Scenario 1

  Bob keeps his 100% tax free TRIS in place, but rolls back his 100% taxable TRIS to accumulation phase on 30 June 2017.

  If this happens, the assets in the newly combined pool would no longer be solely supporting pensions (i.e., the assets would no longer be segregated pension assets).

  This means that the CGT relief would be available for **all assets in this new combined pool** (including the assets that used to be just "Jane's"). As mentioned earlier, this would not include the accumulation account.

  Scenario 2

  Bob keeps both his TRIS in place beyond 30 June, and he restructures his pensions in August when he reaches 65 so that he meets the $1.6m pension limit at that time.

  In this case, presuming new legislation [1] is passed, the assets in the newly combined pool would no longer be considered segregated pension assets on 1 July 2017 because of Bob's TRIS balances.

  Once again, this means that the CGT relief would be available for **all assets in this new combined pool** (including the assets that used to be just "Jane's" but not the accumulation account).

- the way we have solved this in our practice is by simply minuting that they no longer wish to hold specific pools of assets to support particular balances, rather they wish to run the fund on a "pooled" or "combined" basis from 30 June 2017 (at the latest). Importantly, they **don't** need to have collapsed the different wrap accounts etc. by that date – rather they just need to treat the assets in the separate wrap accounts as a combined pool of assets, and each underlying account balance has a proportionate share of that combined pool.

We would highlight this in the minutes prepared to evidence the Fund's eligibility for the relief.

Future tax position of the Fund

It's not all about getting to the 1 July 2017 finish line. People with large SMSFs intend to have these for many years into the future and are acutely aware that the tax treatment looks different going forward.

However, many are surprisingly unaware of some of the important new paradigms – using Bob and Jane as an example:

- Bob and Jane have probably historically planned on the basis that their super will remain largely untouched in their SMSF until they both die. This will all change now. If (say) Bob dies in 2017/18, Jane cannot leave his entire superannuation balance in the SMSF.

  In fact, she is likely to need to withdraw around $2.5m from the fund. Where will this come from? Does the fund have liquid or easily divisible assets that can be sold or transferred to fund this withdrawal?

- In future, their SMSF will pay tax on more of its income. In the first year, they are likely to find that around 55% of the Fund is exempt from tax and the remaining 45% is subject to tax;
- This will include any capital gains they build up after 1 July 2017. Bob and Jane's fund has some capital losses carried forward from previous years ($0.3m).

  Unfortunately, as soon as their Fund starts operating on a pooled basis, any gain realised in the fund is offset against those losses in full (even though only 45% of the gain will end up being taxed). This means they might start using up their carried

[1] Treasury Laws Amendment (2017 Measures No.2) Bill 2017, which was tabled in Parliament on 25 May 2017

forward capital losses much more quickly than they expected.

Conclusion

Even for a relatively simple case like Bob and Jane there are a range of issues to bear in mind. Many of these will need some attention before 1 July 2017 even if the only implementation required is paperwork.

Given the welcome relief of only modest changes to super in the 2017 Federal Budget we can return to focussing on the implementation of the biggest super reforms in 10 years from 1 July 2017.

Heffron has developed a range of tools for trustees, advisers and accountants – see our website for details.