SMSF
Owners'
Alliance
Limited ABN 96 161 052 464
Not-for-profit public company

SMSFOA Members' Newsletter

 # 14/2016 6 October 2016

In this newsletter:

- **A raft of draft legislation on the $1.6 million cap**
- **What we think it all means**
- **What we will be saying to Government about it**

Disclaimer: The observations made in this newsletter are based on our reading of complex draft legislation and what we think it means. It will be some time before the draft legislation becomes law and there may be changes. SMSF Owners does not give investment advice.

The deluge of new super law continues

The latest swag of draft legislation released by the Government last week – this time dealing with the new $1.6 million limit on tax free retirement savings – will add complexity to an already complex system.

The draft legislation – known as Tranche 2 – runs to 85 pages with another 127 pages to explain it.

It's ironic that one of the aims of Tranche 1 – setting the objective of superannuation – was to make the system "simple and efficient".

Instead, we are getting more complicated superannuation law that will increase compliance costs for SMSFs.

Again, the Government has allowed very little time for comment. We've been given just 9 working days to prepare a submission. At least that's a little better than for Tranche 1 when only 7 working days were allowed.

While Tranche 1 was largely about the purpose of superannuation, Tranche 2 has a much greater direct impact on people.

Among other measures, it will:

- Introduce a $1.6 million transfer balance cap and require people with more than that amount in their pension account to either withdraw the excess from their superannuation or shift it to an accumulation account and pay 15% tax on the earnings.
- Lower the income tax threshold (Division 293) on which individuals pay 30% tax on their superannuation contributions from $300,000 to $250,000.
- Reduce concessional contributions to $25,000 per year for everyone, down from $30,000 for under 50s and $35,000 for over 50's.

So some retired people will be paying a new tax on their superannuation fund earnings; more working people will be paying more tax on their contributions and everyone will have less opportunity to make concessional contributions.

Still to come is further draft legislation to give effect to the Government's recent changes to non-concessional contributions. As you will recall, the Government dropped its controversial $500,000 life-time cap on non-concessional contributions, replacing it with a continuation of the current system of rolling caps with a lower annual limit of $100,000 rather than $180,000.

However there's still a window of opportunity before 1 July for people to make non-concessional contributions under the existing rules which set the annual limit at $180,000 and allow a 3-year bring forward.

What's in the draft legislation?

We're working our way through the draft legislation and looking out for expert analysis of how it will work and how it will affect retirement savings – though there has not been much of that so far as the superannuation sector digests the changes.

However, in the meantime, here are some of the key elements of the new measures, some of which will require further clarification and elaboration.

It's important to note that the $1.6 million figure applies in two different contexts.

1. **The overall cap on superannuation**

On 1 July 2017, if the value of an individual's total superannuation balances in all of your funds and accounts is above $1.6 million then from that date you cannot make any further non-concessional contributions. Therefore the current 2016-17 financial year is the final opportunity to make non-concessional contributions.

2. **The "transfer balance cap" (TBC)**

A "transfer balance cap" of $1.6 million will apply from 1 July 2017 whereby:

(a) On that date, no more than $1.6 million (per individual member) can be in a tax-free "pension account".
(b) By that date, if you have more than $1.6 million in your pension account, you must take the excess out. You can either withdraw the excess as a lump sum or shift it to an accumulation account.
(c) If you exceed the $1.6 million TBC, penalties will apply (see Point 6).
(d) There is no limit, subject to the contribution rules, on the total of an individual's accumulation accounts, the earnings on which will be taxed at 15%, as they are now.
(e) Your pension account balance can grow above $1.6 million from capital gains and returns on investments and this will not be counted towards the TBC.
(f) The existing minimum withdrawals, according to age, will continue to apply.

3. **Segregation of assets**

The draft legislation says that a self-managed fund will not be able to "segregate" its assets into different accounts for tax purposes. So, within a fund, you can't assign high-yielding assets to your untaxed pension account and low-yielding assets to your taxed accumulation account. We assume this is on a per member account basis.

4. **Calculation of earnings tax**

For the purpose of assessing earnings tax within a fund, all SMSF assets will be counted together and the tax due assessed by a 'proportioning method'. For example, if you have $2 million in your fund, the tax free balance is $1.6 million (80%) and the remaining balance is $400,000 (20%). So 80% of the earnings on the assets in the account will not be taxed and 20% of the earnings will be taxed at 15%. Again, we assume this is on a per member account basis.

5. **Indexation**

The TBC is indexed to CPI. Instead it should be indexed to wages (AWOTE) or at least to the age pension. If it just indexed to CPI, at current low levels, the relative value of the cap will be reduced in time.

6. **Penalties**

If you exceed the TBC on 1 July 2017 you will pay a 15% tax on notional earnings on the excess, set at 9.2%. If you are caught out a second time the tax rate will be 30%. However if your excess is less than $100,000 and you fix it within 60 days, there is no penalty. As mentioned above, your pension account can grow above the TBC from capital gains and earnings and penalties will not apply.

7. **Multiple funds and earnings**

You will be able to maintain multiple accounts and multiple funds with your superannuation assets distributed among the different accounts/funds. One or more of the accounts can be in pension phase (subject to the $1.6 million cap) and others can be in the accumulation phase. As now, you will pay a 15% tax on the earnings of accumulation funds.

8. **Capital gains treatment**

If you transfer assets out of your pension account to an accumulation fund in order to comply with the cap, those assets will then become liable for capital gains tax. Temporary relief will be provided by allowing the cost base of the asset to be reset as at 1 July 2017. Tax is only liable on capital gains after this date. However, if the asset is not disposed of within a 10 year window, the notional gain ceases to exist and the cost base of the asset will revert to what it was prior to 1 July 2017.

9. **Inheritance of superannuation**

The TBC is not increased to allow inheritance of tax-exempt pensions. However, the beneficiary of a reversionary superannuation income has six months to adjust before the benefit is deemed to be added to his/her superannuation interests.

10. **Compensation payments**

Any personal injury payout (if two doctors certify the person is not able to work again) is added to that individual's transfer balance cap.

11. **Fraud on a fund**

Any losses due to fraud perpetrated on the super fund are added back to the balance. But this does not seem to flow through to losses due to fraud or bankruptcy with regard to underlying investments.

What we'll be saying to the Government

Points we will be making to the Government:

The $1.6 million cap is retrospective.

It is just as retrospective as the proposed $500,000 non-concessional cap that was withdrawn by the Government largely because of widespread concerns it was retrospective. The draft law catches people who had already moved their superannuation into pension mode and exposes those savings to a new tax. Had they known this change was coming, they might have made different decisions about when to retire and how to order their financial affairs. It will require people to re-engineer their superannuation if they have more than $1.6 million in their pension account. The right thing to do would be for the Government to 'grandfather' the existing rules under which people have saved for their retirement.

Its justification is wrong

The Government says it is changing the superannuation rules to stop wealthy people from minimising their tax and engaging in estate planning. The $1.6 million TBC doesn't just affect wealthy people. It affects hard working Australians who have saved diligently throughout their working lives to afford a comfortable living in retirement – just what the Government wants them to do. It is wrong to imply these people are tax dodgers when they have saved according to the rules set by the Government. As to estate planning, where is the line to be drawn between estate planning and prudent saving for a hopefully long retirement? It is in the Government's interest for people to have superannuation savings left over when they die. They won't have been a drain on the public purse in their latter years and the Government taxes any money they leave to non-dependant family members.

It's inadequate

Analysis undertaken by Dr Ron Bewley, former Head of the School of Economics at the University of NSW, shows that savings of $1.6 million are not enough to provide a comfortable standard of living throughout a long retirement, taking into account risks to which most people's superannuation is exposed. While defined benefit schemes enjoyed by politicians and public servants are guaranteed for life, indexed and carry generous benefits to a surviving spouse, savings in SMSFs and mainstream funds are not guaranteed, not indexed and exposed to market and longevity risk. Dr Bewley reckons $3.2 million is closer to the mark.

Compliance will be costly

We are advised by one leading practitioner that the extra annual compliance cost for SMSFs affected by the new law will be in the order of $3,000 to $4,000.

A bedding down period is needed

The Government expects that on 1 July 2017, everyone will know their superannuation balance down to the last dollar. However, it can take months before your accountant has been able to assess the value of the assets in your fund and the tax due. We anticipate there'll be a lot of confusion and honest mistakes made before the system is bedded down.

We'll be proposing an implementation period of 12 months and a matching pause in the penalty for excess amounts in a pension account.

What about the fat cats?

When the Government announced the superannuation changes in the May budget, it said people on defined benefit schemes (politicians, senior public servants, academics, executives in public sector enterprises etc.) would be subject to "broadly commensurate" measures. It said people with entitlement to defined benefit pensions of $100,000 or more would be taxed in a way equivalent to the earnings tax to be applied to retirement savings of more than $1.6 million.

This policy intent also covers "constitutionally protected" schemes covering, for example, judges.

The section of the draft legislation dealing with defined benefit schemes is highly complex because of the different structure of defined benefit schemes compared to the superannuation funds that cover most people.

We have not yet been able to properly analyse this complicated section of the legislation but we suspect that the people on defined benefit schemes – including the senior public servants who advise the Government on tax policy – will still have a sweet deal.

The Australian newspaper has reported that if the notional contribution that senior public servants make to their defined benefit scheme exceeds the $25,000 concessional limit that applies to everyone else, then those notional contributions will be treated as being equal to the concessional cap, even though they may be significantly higher. So these public servants could be getting a benefit not open to everyone else.

Robert Gottliebsen from Business Spectator has written several recent articles on the generous superannuation arrangements for senior public servants and politicians. He points out the unfunded liability for these schemes is somewhere between $314 billion and $600 billion – dwarfing the $120 billion in the Future Fund that was originally set up to cover the cost of public sector pensions.

We've included Robert Gottliebsen's articles in the 'Speaker's Corner' on the home page of our website here:

https://www.smsfoa.org.au/

What next?

The Government wants its package of legislation to pass the Parliament before the end of this year – so we can expect to see the final legislation introduced in October/November.

Labor's position is not yet clear though their Shadow Minister for Financial Services, Senator Katy Gallagher says*: "We will be receiving a briefing from Treasury shortly on the package and will seek more information about the implications for members of defined benefit schemes – along with the effects on all Australians saving for retirement. We will only support changes that are responsible, fair and consistent with our principles – avoiding retrospective laws, targeting concessions to where they are needed most and ensuring that our superannuation system is sustainable for the future."*

Last week, Bruce Foy and Duncan Fairweather met Senator Gallagher to convey the concerns of SMSF Owners' that the legislation is unfair because it is retrospective and, in any case, inadequate. We received a good, if non-committal, hearing from her.

Even if Labor opposes all or parts of the legislation, or succeeds in amending aspects of it, we expect the Government will get the legislation through the House of Representatives where it holds a one-seat majority and can expect the support of independents.

In the Senate, the Government easily has the numbers with the support of the Greens and Xenophon Senators.

Annual meeting

The annual general meeting of the SMSF Owners' Alliance will be held on Wednesday 16 November in Sydney. Members will be sent formal notice of the meeting. All members are welcome to attend but only Principal Members may vote.

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