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Second tranche of draft super reforms released

Treasury has released the second tranche of exposure draft legislation and regulatory amendments to implement their proposed budget measures. Here, IOOF Technical Services Manager, Josh Rundmann, explains the changes and their potential impacts.

The latest release of draft amendments address the following budget measures:

1. Implementing the $1.6m Transfer Balance Cap for income streams from 1 July 2017
2. Lowering of the concessional contributions cap to $25,000 effective 1 July 2017
3. Implementing the 'roll forward' for up to five years of a person's unused concessional contributions cap commencing from 1 July 2018
4. Removal of the tax-exempt earnings on transition to retirement pensions from 1 July 2017
5. Removal of the anti-detriment payment from 1 July 2017

The following analysis deals solely with the broad operation of point 1 above – the transfer balance cap. This covers how the Government keeps track of how much of the transfer balance cap has been used.

How the transfer balance cap is proposed to work

Fundamentally, the transfer balance cap relies on a 'transfer balance account' being maintained by the ATO for each person who has a retirement income stream. Rollovers to retirement income streams such as account-based pensions, lifetime annuities and deferred annuities are seen as 'credits' to this account while lump sum withdrawals or rollovers from these income streams will debit an individual's transfer balance account.

When an individual's transfer balance account is above the transfer balance cap, the excess will need to be removed from the tax-free earnings environment and be subject to notional earnings within super, similar to excess non concessional contributions.

Transfer balance credits

Generally, the value of a retirement income stream on the day it commences, or 1 July 2017 for income streams in place at that date, are credited to the transfer balance account. For new account based pensions, the value is the amount rolled into the income stream at commencement. Existing income streams will be assessed on their market value on 1 July 2017.

Non account based pensions, such as defined benefit pensions, lifetime annuities or market-linked income streams will also be captured as transfer balance credits, with different rules as to how their 'value' is calculated. These rules, for different pensions, are outlined below.

Lifetime income streams

The value of a lifetime income stream is calculated as:

Annual entitlement x 16

The annual entitlement is the sum of all benefits the person is entitled to receive over 12 months from the date at which the value is measured. This will be 1 July 2017 for existing lifetime income streams in place at that date, or the commencement date for income streams established post 1 July 2017.

Market-linked or life expectancy income streams

Similarly to lifetime income streams, the value is calculated as:
Annual entitlement x remaining term
Annual entitlement is defined as per lifetime income streams, whilst remaining term is the number of years left for the term of the income stream at the relevant time, rounded up.

Transfer balance credits and death benefits

Reversionary death benefit income streams are explicitly included as transfer balance credits for the reversionary pensioner, and are added to the transfer balance account six months from date of reversion. Non reversionary death benefit income streams will be included as transfer balance credits immediately for the recipient.
This gives reversionary beneficiaries time to consider how to best manage their affairs without subjecting them to immediate excess tax penalties. However after this grace period the reversionary pension will be included as a standard credit to the recipient's transfer balance account and thus count towards their individual transfer balance cap.
The exposure draft indicates death benefits taken as income streams will not receive any exemption from the existing rules which prohibit the rollover of death benefits to super accumulation accounts within the prescribed period (generally the longer of six months from date of death or three months from grant of Probate).
Child death benefit pension rules, effectively limit the amount a child can receive as a death benefit income stream in line with the below:

- If a death benefit pension is received by the child prior to 1 July 2017 the relevant transfer balance cap is $1.6m
- If the deceased has no pension interests, the child will be subject to the general transfer balance cap, pro-rated based on the proportion of the super benefit they are receive. For example, if they receive 20per cent of the deceased's superannuation death benefit, their cap will be 20per cent of the transfer balance cap in force at the time).
- If the deceased does have at least one pension interest, the cap for the child is the value of the pension on the day of death. This is the case even if a death benefit pension is commenced with both pension and accumulation funds from the deceased – and such a pension would likely result in an excess transfer balance for the child.

Transfer balance debits

Rollovers to commence a pension add to the transfer balance account via a credit. Lump sum commutations from pensions however, reduce the transfer balance via a transfer balance debit. The following list provides for the prescribed transfer balance debits:

- A commutation from an account based pension will reduce the transfer balance by the value of the commutation on the day it is paid. This means it may be possible to increase the amount you have in an income stream over time if the value of the income stream increases. Conversely, commutations made from an income stream which has reduced in value will permanently reduce your effective transfer balance cap.
- Contributions made to superannuation under the 'personal injury exemption' from contribution caps result in a debit for the full value of the contribution being added to the transfer balance account at the latest of the date of contribution, or the date you commence your first income stream. This enacts the exemption the Government had previously announced. Unfortunately, amounts paid under a TPD policy within super do not benefit from this exemption, nor is there an exemption for income streams started under permanent incapacity, without a personal injury contribution.

- Payment splits under the Family Law Act will reduce the original owner's transfer balance amount by the amount split at the operative date of the split, as well as increase the non-member spouse's transfer balance by the portion they receive.
- Commutations from lifetime, life expectancy or market linked income streams will reduce their transfer balance credit, through a pro-rated debit based on the value of the commutation.
- There are provisions for applying to the ATO to apply transfer balance debits in the case of fraud, dishonesty or bankruptcy resulting in a reduction in your retirement benefits.

Finally, if the ATO issue an excess transfer balance notice, the amount stated in the notice is taken as a debit from the transfer balance account at the date of the notice. This is likely designed to stop the case where additional actions after the fact do not require the ATO to continually re-assess the excess transfer balance amount – leading to a very ineffective system.

Transfer balance cap

As announced in the budget, the general transfer balance cap is $1.6m effective 1 July 2017. If the total number of credits, less the total number of debits, at any particular time is above the transfer balance cap the taxpayer will have an excess transfer balance amount, which will need to be dealt with under the excess transfer balance rules discussed below.

Indexation of the cap

The transfer balance cap will index on a quarterly basis in line with CPI, in $100,000 instalments. For persons who have a transfer balance, they will receive a proportional increase in their cap. This is calculated as the indexed amount multiplied by the proportion of their unused cap on the day their transfer balance cap was highest at any time up to the end of the previous financial year, divided by the transfer balance cap as it applied at the earliest time the transfer balance account was at that highest value.
For example, a person has $1.5m in their transfer balance account at 1 July 2017. On 1 July 2020 the transfer balance cap indexes to $1.7m. This person would receive an increase in their transfer balance cap as follows:

$$\$100{,}000\ (\textit{increase in general cap}) \times \frac{(\$1{,}600{,}000 - \$1{,}500{,}000)\ (\textit{unused cap at peak})}{\$1{,}600{,}000\ (\textit{general cap at that time})} = \$6{,}250$$

If this person makes a partial commutation of $800,000 on 1 July 2018, this will reduce their transfer balance of $700,000, being $1.5m reduced by a transfer debit of $800,000. Although the transfer balance is reduced it doesn't affect their transfer balance cap. The transfer balance cap will still be indexed to $1,606,250.

Significant defined benefit interests

There are provisions allowing for the transfer balance cap (for persons with large defined benefit, lifetime, life expectancy or market linked income streams) to have their transfer balance cap equal to the transfer balance value of these interests. This stops people with significant defined benefit income streams from being subject to the transfer balance cap, but restricts their pension benefits to this amount as any new retirement income streams will be in excess of this amount and result in an excess transfer balance amount.
On top of this, the draft legislation includes the reduction in tax concessions for defined benefit incomes over $100,000 per annum by removing all tax concessions on pension payments above this amount.

Consequences of excess transfer balances

Where a person has a transfer account balance over their transfer balance cap, an excess transfer balance amount exists. The ATO will issue a notice to the person advising them of the identified excess.

If corrective action to reduce their transfer balance has occurred (for example, rolling back monies from a pension into accumulation), all the person needs to do is advise the ATO. If no action has been taken, the ATO provides 60 days to reduce the transfer balance by the amount identified in the notice.

After 60 days, if there is still an excess the ATO will issue a 'commutation notice' to a super provider holding funds for the taxpayer, requesting payment of a superannuation lump sum for that member within 30 days of receiving the notice. If the super fund is unable to process the request, they must let the ATO know within 30 days, and if a payment is made the super provider must notify the member within 30 days of when the notice was issued to the super fund.

Additionally, the excess transfer balance will accrue 'notional earnings' which will be taxed at 15 per cent in the individual's own name for 'first offenders'. Subsequent offences will cause earnings to be taxed at 30 per cent. Notional earnings are calculated based on the daily general interest charge rate, on the excess balance every day the excess exists. No tax credit exists for these earnings as they are deemed to have been earned in the tax-free pension phase.

Transitional provisions

For persons with monies in retirement income streams at 1 July 2017, there is an allowance for smaller transfer balance excesses. Minor excesses can be disregarded if remedied within 60 days of 1 July 2017 and the excess is less than $100,000.

There are potential capital gains tax (CGT) concessions for assets backing income streams.. We have not covered proposed transitional CGT concessions at this time and will cover this topic in a future Tech Alert.

Conclusion

The transfer balance cap if legislated in its current form will introduce additional complexity in managing client's retirement income streams.

There is a lot of detail within these amendments and as these are draft legislation, submissions and adjustments may yet be made before the final legislation is passed.