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Super Insights

Federal Budget or Election Platform?

APRIL 2019
Issue: 14

On the superannuation front (and for SMSFs in particular), the 2019-20 Federal Budget was distinctly quiet.

There were positive changes to contribution rules which will help those looking to add to their superannuation beyond age 65. Changes to the rules governing exempt current pension income (ECPI) will also go part of the way towards making it easier for superannuation funds providing pensions to comply with the tax rules. And the Government took the opportunity to announce several other minor superannuation changes that are broadly sensible.

These low key superannuation changes are perhaps not surprising. This Budget is an election platform for the Coalition and as a general rule, immediate cash payments or tax cuts are better vote winners than changes to the superannuation system.

There was also a lot of money splashed around on regulators and generally "doing the right thing" – the ATO, ASIC, APRA, a "reviewer of the regulators" (Financial Regulator Oversight Authority) – as well as funding for the Government's response to the Hayne Royal Commission. It may be many years before we see the true fallout on the industry from the Royal Commission.

CONTRIBUTION CHANGES FOR OLDER AUSTRALIANS

The 2019-20 Federal Budget confirmed the changes to contribution rules announced in the Treasurer's Press Release on 1 April.

Currently, once a person turns 65 they must meet a work test before any further voluntary contributions can be accepted by a super fund (unless the contribution is a downsizer contribution or a work test exempt contribution). This test requires them to have completed 40 hours of gainful employment in a 30-day period. Voluntary employment does not meet the definition of "'gainful" employment, so volunteers or those who only work one day a week generally can't contribute once they turn 65.

The Government has proposed to increase the key age here from 65 to 67 from 1 July 2020.

The measure also extends the ability of those aged 65 and 66 to access the bring forward arrangements for non-concessional contributions (NCCs).

Currently, certain individuals can make up to 3 years' worth of NCCs in a single year (based on the current NCC cap of $100,000, this is $300,000 in a single year). There are rules that limit this opportunity for anyone with a Total Superannuation Balance of $1.4m or more at the previous 30 June but assuming these are met, age is the only other key factor. The final year in which an individual can generally trigger these bring forward rules is the year in which they turn 65.

Should the proposed change be introduced, this would be extended to the year in which the individual turns 67.

Interestingly, and happily, no mention was made of changing the Conditions of Release to increase the current unrestricted access to super from age 65 to 67. This means people in that age group can both contribute and draw down on their super without meeting any other tests.

There was also no mention of amending the downsizer contribution rules which are currently only available for those age 65 or over. Presumably, this means that a non-working 65 to 67 year old will be able to make voluntary contributions and a downsizer contribution (up to the relevant caps) all at the same time.

Nor was there any mention of winding back the work test exempt contributions that are currently legislated to commence from 1 July 2019. These are the rules that allow individuals to contribute one extra year after they last met the work test providing they had a low balance (less than $300,000) at the previous 30 June.

Example

John is 64 and will turn 65 in August 2019 which is when he plans to retire. So far, he has built up very little superannuation and is well within the balance limits for someone wanting to make large NCCs.

He was planning to contribute $100,000 NCC in June 2019, and another $300,000 in July 2019 before turning 65 – a total of $400,000. Under the current rules, he will be ineligible to make further NCCs as in the 2022/23 year he would be well over age 65 and not working and presumably not eligible to make work test exempt contributions (as his balance is likely to

Example cont'd

be greater than $300,000 at 30 June 2022).

With this announcement, however, he wonders if he should re-think this strategy. If he triggers and fully utilises his bring forward in the current financial year by contributing $300,000 in June 2019, under this proposed measure he would be eligible to contribute $300,000 NCC again in July 2021 before he turns 67 – a total of $600,000 in a three-year period.

He would also be able to use the downsizer rules to add a further $300,000 from the age of 65, if he chooses to sell his home and meets all the requirements.

This proposal is a positive one, but the above example shows how hard it is to plan in this uncertain political climate. If the measure doesn't go through – and there's a good chance it won't - he will have missed out on the additional $100,000 he was planning on contributing in June 2019 and will only get $300,000 in prior to age 65 and retirement.

Spouse Contributions

A further part of the proposal by the Treasurer is to increase the age limit for making spouse contributions from 69 to 74 from 1 July 2020, with those aged 65 and 66 no longer needing to meet a work test. This could be a great opportunity to get further monies into super in anticipation of retirement or to equalise balances between a couple.

There is a tax offset available of up to $540 for the contributing taxpayer in respect of eligible contributions made on behalf of their spouse if the spouse's earnings are less than $37,000 a year so an opportunity lies there too.

Take these measures as a positive, however, as always take care with acting on proposals without them becoming law. In this case it may be prudent to wait to see if they go through before making major changes to financial plans.

Maximum age for making contributions

While the proposed measure has extended the period for which contributions can be made without a work test, as well as the rules for spouse contributions, there has been no change to the maximum age for contributions.

Generally, all contributions stop when a member reaches age 75 – or more correctly, the 28th day of the month following their 75th birthday. This will remain and only contributions that are mandated (eg award contributions) can be made after that time.

CHANGES TO EXEMPT CURRENT PENSION INCOME (ECPI)

If the four short paragraphs about ECPI in last night's Budget had been included in the 2016-17 Federal Budget, the Government could have saved actuaries and software providers hundreds of thousands of dollars in software development costs and saved the sanity of accountants and advisers!

Sadly they didn't and their proposed changes will achieve the desired effect of reducing red tape a few years too late.

Nonetheless, we welcome the announcements as part of the solution to simplifying ECPI.

The Government proposed two changes as part of the 2019-20 Federal Budget. Both changes are due to take effect from 1 July 2020, ie the 2020/21 financial year.

Proposed Change 1

Under current law, some superannuation funds are entirely in pension phase all year (providing only retirement phase pensions). Logically, they should be able to claim all investment income as ECPI. Due to a quirk in the law, **some** of these funds still need an actuarial certificate to do so. The Government proposes to remove the requirement to obtain an actuarial certificate under these circumstances.

Proposed Change 2

Under current law, ECPI can be extremely complex for funds that move between different phases such as:

- entirely providing retirement phase pensions for part of the year, or
- providing a combination of retirement phase pensions and other accounts (eg accumulation accounts) for other parts of the year.

The complexity lies in the fact that **some** funds are currently required to claim their ECPI using two different methods for those different parts of the year:

- the "segregated method" when the fund only has retirement phase pension accounts, and

- the "proportionate method" at any other time.

The calculations are tricky, the results are confusing and it is generally a case of overengineering the tax rules.

Our understanding of the Government's proposal is that they will remove the complexity by giving trustees a choice:

- stick with the current system of using both methods when applicable, or
- use the "proportionate method" all year.

The latter was common practice in the past until 2017/18. Generally, the two choices provide much the same tax result but there can be a difference (discussed further below).

There are a number of points to note about Proposed Change 2.

First, under current law not all funds are actually allowed to use the segregated method to claim their ECPI. What is unclear from the announcement is whether this second complication (some funds can segregate and some funds cannot) will also be removed. We speculate it will **not** be changed – if it was removed, Proposed Change 1 above would not be required.

Those that **cannot** use the segregated method have never faced the complexity of having to use different methods for different parts of the year – they have always been required to use the proportionate method all year. Presumably their position will therefore be unchanged.

The proposed change will, however, be very useful for funds that are allowed to use the segregated method and have a period during the year when they are entirely providing retirement phase pensions.

Second, the wording in the Budget papers is not particularly precise but we expect this choice will:

- be made yearly – rather than once and locked in forever,
- also apply for funds that, for example, have no retirement phase pensions for the first 6 months of the year and then move entirely to retirement phase pensions for the remainder of the year. In other words, quite simple cases rather than only the complex situations outlined earlier.

We do not know whether the choice will need to be made in advance or whether it can be made at the end of the year. There are practical challenges either way:

- if the choice is made retrospectively, it may be possible to use it as a means of optimising the fund's tax outcome (and neither the Government or the ATO likes anything that allows their tax revenue to be minimised), but
- if the choice must be made in advance, it is easy to imagine situations where the trustee would find it difficult to predict that they needed to make a choice early enough to make one.

As a general rule, this change is all about simplifying compliance with the tax law. Regardless of the choice they make, some funds will end up paying more or less the same amount of tax. However, it is possible for differences to emerge.

This is perhaps best explained using an example.

Example

Sally is the sole member of her SMSF and has been receiving a pension since she retired. At 30 June 2020, her retirement phase pension was valued at $1m and she had no accumulation account. On 1 April 2021, she made a $300,000 non-concessional contribution which remained in accumulation phase for the rest of the year.

Sally has no other superannuation. Her fund is allowed to claim ECPI on the segregated method.

If no changes were made to the law, Sally's fund would claim her ECPI as follows:

- 1 July 2020 – 31 March 2021: the segregated method. All investment income earned during this time would be exempt from tax. Capital gains and capital losses would be ignored.
- 1 April 2021 – 30 June 2021: the proportionate method. The actuary for Sally's fund would calculate the proportion of the fund's income which is ECPI. In this case, the relevant % would be around 77%. In other words, 77% of all income earned in the last three months of the year would be exempt from tax

Example cont'd

and the remaining 23% would be taxable.

Under the proposed change, Sally **could** ask the fund's actuary to calculate a % that applies to all income for the whole year. In this case, the figure would be around 93%.

If Sally's fund earned its income on a very regular basis (let's say $10,000 per month), it would make very little difference which choice she made.

Using the current rules, the following income would be exempt from tax:

- All of the first 9 months' income ($10,000 x 9 = $90,000)
- 77% of the last 3 months' income ($10,000 x 3 x 77% = $23,100)

In total, $113,100 would be exempt from tax and the remaining $6,900 would be taxed.

Alternatively if she simply used the proportionate method all year, the tax exempt income would be 93% x 12 x $10,000 = $111,600. This is very close to the amount of $113,100 above.

More substantial differences will emerge if Sally's fund earns income unevenly.

Let's say ALL of the fund's income is earned in January 2021. (This could happen, for example, if it came from a capital gain).

If Sally's fund uses both methods (ie the current law) to calculate the ECPI, the fund will pay no tax because the income was earned at a time when the fund was using the segregated method.

If, on the other hand, Sally's fund uses the proportionate method all year, tax will be paid on some of that $120,000 (93% of it will be exempt but 7% will not).

This change will certainly simplify compliance for some funds. We welcome it on that basis but would continue to encourage the Government to remove the major complexity currently in place for ECPI – the fact that some funds are allowed to operate on a segregated basis and others are not. Here's hoping that's exactly what is intended and it is simply unclear from the Budget Papers.

A final point: note that we expect both the changes to ECPI will only relate to funds that are providing account-based or market linked pensions. Funds with defined benefit pensions have quite different actuarial certificate rules.

MISCELLANEOUS AMENDMENTS

Under current law, from 30 November 2019, rollovers to or from SMSFs will need to be made via SuperStream (ie via electronic means rather than paper-based). The aim of this change was to reduce compliance costs for SMSFs and also improve the integrity of the superannuation system by increasing the ATO's ability to verify SMSF data.

Whilst system changes are already in progress to facilitate this change, the Government has proposed deferring the commencement date from 30 November 2019 to 31 March 2021.

From this date, SuperStream will also be expanded to include requests for the release of monies from superannuation via release authorities (eg where an individual has exceeded a contribution cap).

CHANGES ALREADY LEGISLATED

As is often the case, in last night's Federal Budget the Government took the opportunity to remind us of some of the changes which they have already legislated. One of these, which has not received much air-play to date, is the change to default insurance and inactive member accounts.

When setting up an SMSF, it is a common strategy for individuals to roll over most of their accumulated balance from an industry, employer or other retail-type fund leaving a small amount behind so that they can keep their insurance cover going. Likewise, opening a retail or industry super account just to obtain insurance cover is an often used strategy.

New laws recently legislated mean individuals in these situations should review the account which holds their insurance cover, otherwise that cover may be lost.

The Detail

From 1 July 2019, trustees of a MySuper or choice fund are prohibited from providing insurance where:

- the member's account is inactive for a continuous period of 16 months or more, and
- the member has not elected to obtain or maintain insurance in that fund.

In other words, from 1 July this year a member must "opt-in" to continue to hold insurance in an inactive super account, or make the account active. Failure to do so could mean the trustee will cancel the insurance cover.

What is an Inactive Super Account?

A member's account is considered inactive simply if no contributions or rollovers have been received into it for a period of 16 months. Once a rollover or contribution is received, the 16-month period is reset.

This change affects insurance arrangements put in place both before or after 1 July 2019, and inactivity prior to this date counts towards the 16 months. For example, a super account where no contributions or rollovers have been received since 1 March 2018 will be considered inactive on 1 July 2019.

What do individuals need to do?

Where an individual holds a super account somewhere with insurance cover that they intend to remain in place, and the account is in danger of being considered "inactive", they can either:

- contribute or rollover an amount to the account to make it active (if they are eligible to do so), or
- submit a valid election in writing to obtain or maintain the insurance cover.

Contributing or rolling over to the account will only make it active for up to 16 months, after which they would have to do either of the above again, whereas individuals only have to submit the opt-in election once, so it's a more permanent solution.

Individuals who have insurance arrangements in their super accounts and who might be affected by these new rules can expect to hear from their super fund in the next few months. They will be given the opportunity to elect (in writing) for their insurance to continue (if they choose to do so).

WHAT DIDN'T MAKE IT

What didn't make it into the Federal Budget is often every bit as interesting as what did. In this Budget, for example:

- we saw changes that align important superannuation *contribution* ages with the age pension age (67) but no change to the age at which individuals can *access* their superannuation (this remains 65 at the latest). We certainly expect this to increase to 67 at some point and this Budget might have been the perfect time,
- we have become accustomed to seeing contribution caps fall but none were changed this time around,
- perhaps not surprisingly there were no changes to Limited Recourse Borrowing Arrangements for SMSFs (this won't stop someone calling for yet another review though), and
- sadly, there were no changes announced for legacy pensions (such as lifetime or life expectancy pensions). Whilst these were briefly popular in SMSFs and from a limited number of annuity providers many years ago, they now often represent a major headache for the few thousand individuals who still have them. The superannuation industry has begged Government, Treasury and the Australian Tax Office to find a solution here for many years and has proposed many and varied options. It would seem that yet again, this has fallen on deaf ears.

WHERE TO NOW?

These are Budget announcements, not law. As usual we could recommend caution rather than immediate action – perhaps even more so this year since an election is imminent and the Coalition faces significant challenges to remaining in Government. We recommend deferring any major and irreversible change in plans until after the relevant changes are law.

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