TRANSFER BALANCE CAP

Restrictions on pension accounts

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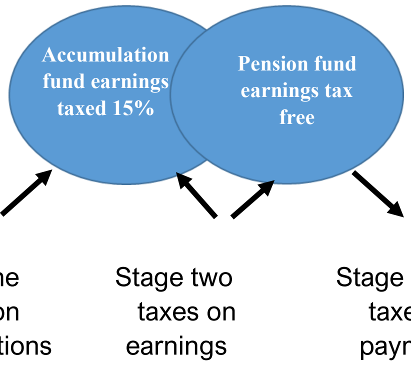
BACKGROUND

On 1 July 2017, legislation came into effect that restricted the amount individuals may retain or move into the pension phase of superannuation.

Before explaining further, it's important to revisit the superannuation model.

The three tax points of the superannuation system:



- Contributions are taxed at either 15% (concessional contributions) or 0% (non-concessional contributions).
- Earnings are taxed at up to 15% in the accumulation phase and are tax free in the pension phase.
- Pension payments are taxed at between 0% (for the Tax-free Component for all pensioners and the taxed element of the Taxable Component for those over 60) and 47% (for any untaxed component for those under 60 on the highest marginal tax rate).
- Lump sum payments are taxed at between 0% and 32% depending on age, tax components and whether the low rate cap has been reached.

Let's look at the implications for stages two and three of the model, that is, the tax on earnings within the fund and the tax applying to benefits leaving the fund. The 1 July 2017 legislation changes the amount of tax actually paid in stages two and three through capping the amount you can have in pension phase.

Contributions are paid into an accumulation fund. While in that fund, contributions are invested and the earnings taxed up to 15%. So, if an accumulation fund earns a gross return of 10%, the net return to members will be 8.5% (after the 15% in tax has been removed). When the person retires, the accumulation fund balance is typically rolled over into a pension fund, where the tax rate drops from 15% to 0%. If the pension fund earns 10% gross, the net return will also be 10%. Once their superannuation funds are in pension phase, an individual is obligated to draw down an annual pension payment, calculated according to the account balance and their age. For individuals aged 60 and over, this income payment is 100% tax-free.

Until 1 July 2017, there were no limits on the amount that could be transferred from accumulation to pension phase. There were annual limits to what could be placed into the accumulation phase in the first instance, so there was an indirect limit on the amount that could ultimately end up in pension phase. However, these contribution limits were considerably more lax in decades gone by, so it was quite possible for an individual to have a considerable amount in accumulation phase.

ONLY ALLOCATED PENSION/S

From 1 July 2017, however, individuals are subject to a $1.6 million Transfer Balance Cap (TBC). From 1 July 2021, this cap is $1.7 million. This limits the amount of money they can transfer from accumulation to pension phase to $1.7 million.

Let's take Maisy as an example. She retires after 1 July 2017 and has $2 million in her accumulation account. The maximum that she is able to roll over to a pension fund is (currently) $1.7 million. She may leave the remaining $300,000 in accumulation phase or she could withdraw it from superannuation altogether if she wanted.

What if Maisy had two accumulation accounts, with $1 million in each? In this instance neither fund would know she's exceeded her TBC so she could move both into the pension phase. Unfortunately, as part of the new arrangements superannuation and pension funds will provide information to the ATO about individuals and fund balances. The ATO will use tax file numbers to identify superannuation accumulation and pension accounts and determine excess balances inside funds.

In this situation, the ATO would issue a determination to Maisy and advise her of the amount of her excess transfer balance. The determination would also include notice of the default commutation authority that the Commissioner intends to issue. In Maisy's example, her two pension funds are the ABC fund and the XYZ fund and between the two she has an excess transfer balance of $300,000. The Commissioner will pick one of these funds (for example the ABC fund) and issue a commutation notice. Maisy can change that notice, requesting that the commutation take place in the XYZ fund, or across both. She must make this election within 60 days of the Commissioner's determination.

This would again suggest that someone in this position should stay in this environment as long as possible.

It would take time for the Funds to report and for the ATO to process the information and issue a commutation notice. There would then be another 60 days to make an election and for funds to stay in the tax-exempt environment.

Unfortunately this won't be the case. Regardless of when the matter is resolved, an Excess Transfer Balance tax of 15% on notional earnings would be payable from the date of the breach for the first breach. This increases to 30% for subsequent breaches. If this tax is not paid by the due date, interest will accrue at the rate of the Government's General Interest Charge (GIC rate).

Of course, this is a very simple example of someone who has money inside one or more allocated pensions, without also having any defined pension such as CSS. We discuss these more complex cases on page 4.

Despite this being a simple case, the ongoing administration is complex. Say that a year later Maisy makes a lump sum commutation (withdrawal) of $100,000 from her allocated pension. This acts as a 'credit' to her TBC, giving her room for extra money to be transferred into an income stream at a later date. The same, however, does not apply for pension payments or falls in value because of negative investment returns.

These commutation rules also apply to withdrawals because of family court arrangements. Say that Maisy and her husband divorce and, as part of the settlement, he gets $700,000 from her $1.7 million allocated pension. This is transferred to him, so therefore forms part of his TBC. Maisy's TBC is reduced by the

There's also complexity with proportioning of the limit. The $1.7 million TBC will be indexed and move up in $100,000 increments. Given that this is only indexed in line with the consumer price index, it could take considerable time to see any movement. This is effectively inventing a new form of tax bracket creep, with money in accumulation funds being invested and the transfer balance cap only growing with the consumer price index.

Say that in five years the indexation benchmark was achieved and the new TBC was $1.8 million (an increase of 5.88%). Also assume that when the TBC was $1.7 million, an individual started an allocated pension with $400,000 (leaving $1.3 million of the current TBC available). When the new $1.8 million limit starts, the individual will have a personal TBC of $1.776 million. This is made up of the original remaining TBC of $1.3 million that would be indexed at the same rate that the full Cap is indexed —in this case 5.88% (1.0588 x $1.3 million or $1,376,440) plus the original amount moved into the pension phase.

Perhaps one of the most worrying aspects of this is the treatment of reversionary (death) benefits. This can get quite tricky.

Let's say that Harry and Sally both have allocated pensions of $1 million, so are both under their TBC. Harry dies and leaves Sally as the nominated reversionary beneficiary. Sally now has her $1 million allocated pension and Harry's $1 million allocated pension. Now that she has two allocated pensions totalling $2 million, she will then exceed the $1.7 million TBC by $300,000 (assuming there has been no further indexation of the Cap).

In these situations the ATO will wait 12 months before counting Harry's $1 million reversionary pension against Sally's TBC and issuing the excess determination. At that stage, a total of at least $300,000 will have to be commuted from the pensions. If Sally commutes the $300,000 from Harry's pension, the resultant death benefit can't stay inside superannuation as it would breach superannuation conditions. It would have to be paid out of the superannuation system. Alternatively, if Sally commuted the amount from her original pension, this could be rolled back to accumulation as it's not a death benefit.

ONLY DEFINED BENEFIT PENSION/S

Again, we'll look first at the easy example of someone who has only a defined pension benefit, such as CSS, PSS, DFRDB, MSBS or UniSuper. We'll discuss the more complex examples where someone has both defined pensions and allocated pensions on page 5.

Under the new laws, the annual rate of defined benefit pensions are multiplied by 16 to give them a value to be measured against the TBC. Therefore, if someone claims a defined benefit pension of $106,250, it's deemed to use up $1.7 million ($106,250 x 16) of their TBC. So they've used up their entire (current) TBC with the defined benefit pension.

The 16 x is a throwback to the reasonable benefit limits days of the 1990s. A similar methodology was used, with pensions multiplied by a factor to give them a lump sum equivalent. However, under reasonable benefit limits, variables such as the level of indexation, age of the recipient and level of reversion were taken into account to determine the factor. A factor of 16 times may have applied to a 55-year-old pension recipient, but a lower factor of 12 times would have applied to a 65-year-old. This common sense reflected the fact that an older recipient's pension was less valuable as they had less time to live and therefore benefit from it. This is not the case with the new legislation, where everyone gets 16 times.

Another great inequity with this new one-size-fits-all approach is that the 16 times figure is applied against the gross value of the pension, when there could be significant net differences.

Let's look at the case of Harold, who has a $106,250 UniSuper pension. This is 100% funded and therefore consists of taxed and tax-free components. His wife Maude has a $106,250 CSS pension, which is totally unfunded and is taxed, with a 10% tax offset. Harold's net income is $100,000 a year, while Maude's is $90,344.

In spite of this difference in net outcomes, the gross value of both pensions (the $106,250) is multiplied by 16, meaning that they both use up the $1.7 million of the TBC. Under reasonable benefit limits in the 1990s, unfunded benefits, which were subject to higher rates of tax, were given higher limits, reflecting the fact that not all pensions are created equal.

You also have the situation where a CSS pension (indexed to the consumer price index) and a parliamentary pension (indexed in line with movements in parliamentary salaries) are both converted using a factor of 16. Enough said about that!

In all of these cases, the pension could be comprised of one, two or all three of the following tax components:

- tax-free component
- taxable taxed component
- Taxable untaxed component.

It's important to identify these components as there's a pecking order in how they're counted and treated (if they exceed the TBC). The pecking order is that the tax-free and taxed taxable components are combined and counted first, with the untaxed taxable component added last. It, therefore, doesn't matter if there is one pension (with multiple components) or multiple pensions (all with single components).

For example, Jenny has a $110,000 PSS pension which comprises a combined annual tax-free and taxed taxable amount of $40,000 and an annual untaxed taxable amount of $70,000. The $40,000 tax-free and taxed taxable component is counted first, using up $640,000 (16 x $40,000) of the $1.7 million TBC. The $70,000 untaxed taxable component is counted second, using up $1,120,000 ($70,000 x 16) of the TBC. When the two are combined, Jenny has used up $1,760,000 of her $1,700,000 TBC. She is $60,000 over her TBC.

When divided by 16, this $60,000 excess equates to $3,750 of income payments. It's deemed that this excess income payment is coming from the untaxed taxable component (as it's counted second). The punishment for exceeding the cap is that this $3,750 will lose the 10% tax offset that would normally apply to an untaxed pension, so Jenny will pay $375 more tax each year.

If Jenny's $110,000 pension had been totally constructed of tax-free and taxable components, there would be $3,750 of tax-free and taxed taxable pension exceeding the TBC. In this situation, 50% of this excess (or $1,875) is added to her other income to be taxed at her marginal rate.

This produces quite different results. If this is Jenny's only income, the $1,875 of income falls below the tax-free component of $18,200, so she'll pay no extra tax on it. If she had (for example) $37,000 of extra taxable income, this $1,875 would be taxed at 34.5%. Again, it's ironic that 50% of a tax-free component can be subject to tax. A component is tax-free as it's already been taxed. This is double taxation in this case.

BOTH DEFINED BENEFIT AND ALLOCATED PENSIONS

Where a person has a defined benefit pension and an allocated pension, both are assessed against the TBC of $1.7 million. Again, there's a pecking order.

First up, the defined benefit is counted, with the tax-free and taxed taxable components counted initially, and then the untaxed taxable component. On top of that, the allocated pension is counted last.

Using the example of Jenny above, we know that her defined benefit pension alone has a TBC value of $1,760,000, against a cap of $1,700,000. As a result of exceeding her TBC, the part of her defined pension deemed to be 'in excess' incurs a tax penalty.

This could occur if, say, Jenny already has an allocated pension and then commences a defined benefit pension.

If Jenny's allocated pension was valued at $600,000, this is added on top of her defined benefit in calculating any excess of her TBC. As her defined benefit pension would be over the TBC, 100% of her allocated pension will also exceed the TBC. She will have to commute the allocated pension and roll it back to accumulation phase.

Jenny's husband Craig has a defined benefit pension (DFRDB). His pension is $70,000 a year, which accounts for $1,120,000 ($70,000 x 16) of his $1,700,000 TBC. Unlike Jenny, who's over her TBC, Craig still has some $580,000 scope left in his TBC.

One solution may be for Jenny to commute $330,000 from her allocated pension. If Craig is under 67 and has not made any NCCs in the current financial year nor exceeded the then annual NCC cap in either of the two previous financial years, he could make a non-concessional contribution of $330,000 to his super fund and turn this into an allocated pension. This allocated pension would then be added to his TBC, which would bring it up to $1,450,000. This would mean that Jenny would only have to withdraw or commute $270,000 of the allocated pension back to accumulation phase.

Jenny would also be wise to commute the remaining $270,000 back to her superannuation account as early as possible. For every day that she has an amount that exceeds her TBC, she will be paying an extra 15% tax on this and the notional earnings of the excess, representing the tax she'd have paid had this been moved back into accumulation from 1 July 2017.

As stated earlier, it doesn't matter how long it takes the ATO to catch up with you, the Excess Transfer Balance tax on notional earnings applies from the first day the TBC is exceeded.

WILL YOU BE AFFECTED?

The easiest way to work out whether you'll be affected by the TBC arrangements is to use the following formula:

(Gross annual defined pension x 16) + balance of allocated pension

If the balance is greater than (currently) $1.7 million, you're caught under the TBC rules.

If you are caught under the TBC rules, there's no one-option-fits-all solution. The example of Jenny and Craig above will apply only if a certain number of variables are met (Craig has to be under 67 and not have made any NCCs over the current nor exceeded the NCC cap in either of the two previous financial years). Jenny also has to be comfortable with the idea of legally handing over $330,000 of her money to Craig.

It may well be that this gives rise to other issues that need to be taken into account. If Jenny and Craig go with the above strategy, it probably makes sense for the $300,000 transferred to Craig to be all bucket two and three assets, leaving the bucket one assets with Jenny in accumulation. This is because the accumulation account tax of 15% compared to pension account tax of 0% is better applied to low-yielding rather than high-yielding assets. If cash is earning 1.5% gross, there's only a 0.225% difference between paying no tax and paying 15%. If shares are earning 10%, there's a 1.5% difference.

If you are affected, it's certainly in your interest to make the necessary changes as early as possible. Every day the excess situation exists, you will be racking up excess transfer balance tax on the notional earnings.

Companion documents:
Allocated Pensions and Transition to Retirement
Allocated Pensions