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eNewsletter
Exclusive Client Email Newsletter
May 6, 2016

Federal Budget 2016: Super Reforms a 'Curate's Egg'

This year's Federal Budget includes the most significant changes to Australia's superannuation system since Costello's sweeping Simpler Super reforms in 2007, plus tax initiatives to support low income earners and small businesses.

On Tuesday 3 May, Federal Treasurer Scott Morrison handed down the Federal Budget for the 2016–17 financial year. The Budget measures are designed to aid Australia's transition from a mining-led economy to a stronger, more diversified economy that encourages innovation and supports job growth.

Although the Budget offers tax breaks to support low income earners and small businesses, far-reaching changes to superannuation rules strike us as what the English call a "curate's egg."

The term comes from a cartoon published in the humorous British magazine *Punch* in 1895, which showed a timid-looking curate (assistant pastor) by the name of Mr Jones eating breakfast in his bishop's house. The bishop says: "I'm afraid you've got a bad egg, Mr Jones." The curate replies, desperate not to offend his eminent host and future employer: "Oh no, my Lord, I assure you that parts of it are excellent!"

Of course, this clearly cannot be true of a bad egg. So a "curate's egg" entered the lexicon, describing something that is partly bad and partly good.

Key Budget announcements likely to impact the retirement strategies of many Australians include:

- reduced caps on concessional and non-concessional super contributions
- tax offsets for low income earners and those with low super balances
- reduced tax concessions on super contributions for high income earners
- a reduced company tax rate for small and medium businesses.

Despite the Coalition Government being elected 3 years ago on a pledge not to introduce any adverse changes to superannuation in this term, and the Treasurer promising last November that people would face "nothing that punishes or penalises them retrospectively" in super, we are dismayed to report that this is exactly what has occurred in this Budget.

Of course, these proposals are not yet law, and we expect there will be a strong campaign by financial services and professional bodies to lobby the Government to remove the retrospective aspects of the new rules before the legislation is drafted and put to Parliament after the 2 July federal election. To what extent this is successful, time will tell.

But First, the Big Picture

The Reserve Bank's decision to cut the official cash rate by 25 basis points to a new low of 1.75% on Budget day underlines the work that still needs to be done in Australia's transition from the mining boom to a broader-based economy.

Although the economy is projected to grow by 2.5% in 2015-16, a fall in the annual rate of inflation to 1.3% in the March quarter suggests further stimulus is needed.

The budget deficit is forecast to rise to $37.1 billion in 2015-16 and the Treasurer said the budget is expected to remain in deficit until 2020-21. Net debt is expected to reach $326 billion this financial year, or 18.9% of GDP.

Despite a bounce in prices for iron ore and coking coal in 2016, Government revenues have been hit by the higher Aussie dollar and sluggish wages growth. Unemployment is expected to ease to 5.5% and wages to rise by 2.5%, barely ahead of inflation at 2%.

As part of its drive to promote jobs and growth, the Government will spend $50 billion on infrastructure projects. This includes funding for a series of road and rail projects, including Metro rail projects in Melbourne and Sydney and motorways in Queensland.

The proposed Brisbane to Melbourne inland rail link has received $594 million for land acquisition and preliminary work. Regional Australia will also benefit from a $2 billion water program to invest in new dams and pipelines.

Increased infrastructure spending and tax cuts for small to medium enterprises are positioned as the main drivers of growth and jobs.

Superannuation changes

Contribution caps reduced

From 1 July 2017, the cap on **concessional contributions** will reduce to $25,000 a year for everyone, regardless of age. Currently the concessional contributions cap is $30,000 under age 50 and $35,000 for ages 50 and over. Those who have the capacity to fully utilise the current caps for this financial year and 2016-17 should consider doing so. Unfortunately, this reduction in the maximum cap takes no account of the fact that many super investors are only in a position to salary sacrifice significant sums in their later years just before retirement.

A **lifetime cap of $500,000 for non-concessional contributions** (NCC) has been introduced, **effective <u>immediately</u>**. This lifetime NCC cap will be indexed to Average Weekly Ordinary Time Earnings in increments of $50,000. This new rule replaces the existing annual cap of $180,000 (or $540,000 every three years under the bring-forward rule).

The lifetime cap is retrospective in that it takes into account all non-concessional contributions made from 1 July 2007. Contributions made after the Budget announcement that exceed the cap (taking into account all previous non-concessional contributions) will need to be removed or will be subject to the current penalty tax arrangements. However, there will be no penalties if the cap has been reached or exceeded prior to the Budget announcement (7.30pm AEST, 3 May 2016).

This is very bad public policy. To illustrate how ridiculously low the lifetime limit of $500,000 is one merely has to consider the maximum amount of $9 million in today's money that a 25-year-old could have contributed at $180,000 pa under the previous rules in non-concessional contributions over 50 years to age 75, assuming of course that he had the resources to do so. Admittedly, this effective lifetime maximum was overly generous, but the new replacement lifetime limit is an incredible reduction of 94.5%.

That a $500,000 retirement nest egg is less than ideal is demonstrated by the fact that at a 5% pa yield, it would generate an retirement income of only $25,000 pa without capital drawdown.

Moreover, as a result of the retrospective reach of the new rule going back almost 9 years, many super fund members will find that they have exceeded the $500,000 cap already – as a result of contributing the proceeds of a property sale or a bequest, or just implementing a recontribution strategy to minimise future tax for their adult children beneficiaries – and will not be able to contribute one more dollar of after-tax savings to super for the rest of their lives. This is simply wrong, unfair and unjust.

What should have been put in place is a more realistic lifetime cap of at least $1 million superimposed on top of existing limits, and with no retrospective effect. The Government could and should have avoided this poorly thought-out proposal by consulting with the industry beforehand.

A positive reform is that individuals with super balances under $500,000 who don't reach their concessional cap in a given year will be able to carry forward their unused cap amounts on a rolling basis over five consecutive years, starting on 1 July 2017.

Besides helping, for example, mothers who have been on parenting leave catch up on their missed contributions, this rule will come in handy for those with a year of high income as a result of realisation of a capital gain.

Contribution eligibility requirements eased

The current **work test** that applies for people making voluntary contributions between age 65 and 74 will be **removed as of 1 July 2017**. This will make it easier for older Australians to contribute to super.

Individuals also will be able to make **contributions for a spouse** aged under 75 (up from age 70) without requiring the spouse to satisfy a work test.

Tax exemption on TTR pension earnings removed – but strategy still useful

The tax exempt status of income from assets supporting transition to retirement (TTR) pensions will be removed **from 1 July 2017**, with earnings to be taxed at the Super accumulation tax rate on earnings of up to 15%. It is generally accepted that the tax-free earning environment added an additional 0.5% or so to the earning rate. This change will apply regardless of when the TTR income stream commenced. This is another case where current arrangements should have been "grandfathered" or exempted.

Further, TTR pension recipients will no longer be able to treat certain income stream payments as lump sums for tax purposes, which currently makes them tax-free up to the low rate cap of $195,000 – a tax-minimisation strategy used by those under 60.

There is no doubt that the reduction in the maximum concessional contribution cap to $25,000 pa and the removal of the tax-free environment for TTR pension earnings takes the shine off the use of the TTRP strategy. However, we believe it can still be a useful strategy for those over age 60 for the following reasons:

–The proposed changes don't come in for another13.5 months – and they will still have to run the gauntlet of the new Lower House and Senate, presuming team Turnbull is re-elected.
– the TTR pension payment is still tax-free and the can help supplement contributions up to the full $25,000 cap, so that it is fully utilised.
– The salary sacrifice strategy still provides a significant tax saving between the 15% contribution tax and the TTR recipient's marginal tax rate (34.5%, 39% or 47%)
– Implementation of the strategy imposes an important and sometimes necessary savings and budgeting discipline.

For these reasons, we can still see the Transition to Retirement Pension strategy still being a useful tool for many clients once they reach age 60 – however, this will need to be decided on a case-by-case basis.

Transfer balance cap introduced for pensions

On 1 July 2017, a transfer balance cap of $1.6 million will be introduced to restrict the total amount of super that an individual can transfer from the accumulation phase to the tax-free pension phase. If an individual accumulates more than $1.6 million, he or she will be able to maintain the excess in the accumulation phase (where earnings will be taxed at up to 15%).

Those already in the pension phase on 1 July 2017 and whose balances exceed $1.6 million at that time will need to either transfer the excess back into the accumulation phase, or withdraw it from super. While in our view the unlimited tax-free status of all super pensions was too good to last, again existing super pensions should have been “grandfathered.”

Once having satisfied the $1.6 million threshold on 1 July, 2017, the pension account balance will continue to qualify for zero tax status on earnings regardless of how much it grows.

While many clients in this position would be better off leaving the excess in their super (given the concessional tax rate of 10% to 15% on earnings), in some cases we may recommend withdrawing the excess from super to invest in your own name(s) to take full advantage of your tax-free threshold, or to re-invest in super in the name of your spouse.

Furthermore, it will be necessary for SMSF investors with high balances to seek advice at the time as to what assets to keep in pension mode and what assets to transfer to accumulation phase, depending on their unrealised capital gains position.

The transfer balance cap of $1.6 million will be indexed to inflation, in $100,000 increments.

Individuals who breach the transfer balance cap will be subject to a tax on both the excess amount and the earnings on the excess amount —similar to the tax treatment for excess non-concessional contributions.

Threshold reduced for additional contributions tax

Division 293 tax — an additional 15% contributions tax payable by high income earners with earnings over $300,000 — will also apply to those with incomes above $250,000 **from 1 July 2017.**

For Division 293 purposes, the definition of ‘income’ includes:
- taxable income (including the net amount on which family trust distribution tax has been paid)
- reportable fringe benefits
- total net investment loss (including net financial investment loss and net rental property loss)

- low tax contributions (non-excessive concessional contributions) including super guarantee, salary sacrifice and personal concessional contributions.

Division 293 tax will apply to any low tax contributions that exceed the $250,000 threshold. The following table compares the tax concessions applicable on concessional contributions at various marginal tax rates.

Marginal tax rate*	Contributions tax	Tax concession
21%	15%	6%
34.5%	15%	19.5%
39%	15%	24%
49%	15%	34%
49%	30%**	19%

*Including Medicare Levy and Temporary Budget Repair Levy

**Includes additional 15% contributions tax (Division 293)

Given the difficulties in getting money into super in future due to the lower contribution limits, it would be wise to pay the additional contributions tax yourself if you have the means rather than have this tax deducted from the super fund.

Low Income Superannuation Tax Offset to provide continuity

A Low Income Superannuation Tax Offset (LISTO) will be introduced to reduce the tax on contributions for low income earners. The LISTO will replace the Low Income Superannuation Contribution (LISC) scheme when it is abolished on 1 July 2017.

The LISTO will provide a non-refundable tax offset to super funds, based on the tax paid on concessional contributions up to a cap of $500. The LISTO will apply to members with adjusted taxable income up to $37,000 that have had a concessional contribution made on their behalf.
The ATO will determine a person's eligibility for the LISTO and advise their super fund annually. The fund will contribute the LISTO to the member's account.

Access increased to tax offset for spouses

In another positive reform, the current spouse super tax offset will be available to more people when the spouse income threshold changes **on 1 July 2017**. The threshold will increase from $10,800 to $37,000.

A contributing spouse will be eligible for an 18% offset worth up to $540 for contributions made to an eligible spouse's super account.

Deductions for personal contributions extended

As of 1 July 2017, Australians under 75 will be able to claim an income tax deduction for any personal contributions made to a complying super fund up to their concessional cap. This effectively allows anyone, regardless of their employment circumstances, to claim a deduction for their personal contributions up to the value of the cap.

Individuals will need to notify their super fund or retirement savings provider of their intention to claim the deduction, before lodging their tax return.

These amounts will count towards the concessional contributions cap and will be subject to 15% contributions tax. Individuals can choose how much of their contributions to deduct — however, if they end up exceeding their concessional cap the deduction claimed on the excess contributions will have no effect, as these amounts will be included in the member's assessable income.

Members of certain prescribed funds would not be entitled to deduct contributions to those schemes. These include all untaxed funds, all Commonwealth defined benefit schemes, and any state, territory or corporate defined benefit schemes that choose to be prescribed.

Anti-detriment payments removed

Anti-detriment provisions will be abolished **from 1 July 2017**, effectively removing the ability of super funds to increase lump sum death benefits when paid to eligible beneficiaries.

The anti-detriment provisions currently allow a fund to claim a corresponding tax deduction where it is able to increase the amount of a member's death benefit to compensate for the tax paid on contributions.

Changes to defined benefit schemes

From 1 July 2017, the cap on concessional contributions will reduce to $25,000. Individuals with super balances under $500,000 who don't reach their concessional cap in a given year will be able to carry forward their unused cap amounts on a rolling basis over five consecutive years.

The Government will include notional (estimated) and actual employer contributions in the concessional contribution cap for members of an unfunded defined benefit schemes and constitutionally protected funds. For individuals who were members of a funded defined benefit scheme as at 12 May 2009, the existing grandfathering arrangements will continue.

A lifetime cap of $500,000 for non-concessional contributions has been introduced, effective immediately. Non-concessional contributions made into defined benefit accounts and constitutionally protected funds will be included in an individual's lifetime cap.

If a member of a defined benefit fund exceeds their lifetime cap, ongoing contributions to the defined benefit account can continue but the member will be required to remove, on an annual basis, an equivalent amount (including proxy earnings) from any accumulation account they hold.

To broadly replicate the effect of the proposed $1.6 million transfer balance cap, the Government has announced that pension payments over $100,000 a year paid to members of unfunded defined benefit schemes and constitutionally protected funds providing defined benefit pensions will continue to be taxed at full marginal rates. The 10% tax offset will be capped at $10,000 from 1 July 2017.

For members of funded defined benefit schemes, 50% of pension amounts over $100,000 per year will be taxed at the individual's marginal tax rate.

Super objective to be enshrined in law

The objective of superannuation is to provide income in retirement to substitute or supplement the age pension. The Government says it will embed this objective in a standalone Act, with an accountability mechanism to ensure that new superannuation legislation is considered in the context of the objective.

It is a shame this did not occur before some of the counterproductive measures above were determined. Public policy that severely restricts the ability of pre-retirees to contribute to super is hardly likely to increase the number of self-funded retirees.

Tax changes

Company tax rate reduced

Starting **from 1 July 2016**, the company tax rate will be reduced to 25% over 10 years. Currently, small companies with aggregated turnover less than $2 million pay tax at a rate of 28.5%. Franking credits will be able to be distributed in line with the rate of tax paid by the company making the distribution.

Financial year	Companies with turnover below	Applicable tax rate
2016-17	$10 million	27.5%
2017-18	$25 million	27.5%
2018-19	$50 million	27.5%
2019-20	$100 million	27.5%
2020-21	$250 million	27.5%
2021-22	$500 million	27.5%
2022-23	$1 billion	27.5%
2024-25	All companies	27%
2025-26	All companies	26%
2026-27	All companies	25%

Small business tax discount increased

The unincorporated small business tax discount will be increased in phases over 10 years from the current 5% to 16%. The following table indicates when the discount rates will apply.

Financial year	Discount rate
2016-17	8%
2017-18 to 2024-25	10%
2025-26	13%
2026-27+	16%

Personal income tax reduced

From 1 July 2016, the 32.5% personal income tax threshold will increase from $80,000 to $87,000.

This measure will reduce the marginal rate of tax on income between $80,000 and $87,000 from 37% to 32.5%. For example, a taxpayer earning $87,000 will save $315 per year as a result.

This will ensure the average full-time wage earner will not move into the second highest tax bracket in the next three years.

Proposed tax rates 2016–17	
Taxable Income ($)	**Tax Payable ($)***
$0 - $18,200	0%
$18,201 - $37,000	19% over $18,200
$37,001 - $87,000	$3,572 + 32.5% over $37,000
$87,000 - $180,000	$19,822 + 37% over $87,000
$180,000+	$54,232 + 45% over $180,000

*Excludes Medicare Levy and Temporary Budget Repair Levy

Crackdown on Multinational Tax Avoidance

The Government will spend $2 billion on new measures to crack down on multinational tax avoidance. Multinational corporations will face a diverted profits tax on income they attempt to shift offshore, at a penalty rate of 40%. This will be policed by a 1,000-member ATO task force.

The Bottom Line

Even if all these super reforms are legislated without amendment, most super investors will not be disadvantaged and may even benefit from some of the positive changes. It is important to note that superannuation will still be the best tax shelter for all Australian investors by a big margin. So we will continue to give you the best professional advice, so you can avoid the traps and continue to benefit from the significant tax advantages.

If you have any queries or concerns regarding your financial situation, please contact your Retirewell Adviser.

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