Retirewell eNewsletter

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Analysis of the proposed changes to super rules

The first thing to remember about the changes to the superannuation rules announced by the Federal Government last week is that they are just proposals, which will not be legislated in their current form until after the election on 14 September, and only if the Labor Government is returned.

On present indications, the risk of this happening is negligible.

However, it is possible that an incoming Coalition Government may legislate some of the proposed changes, in line with the Opposition Leader's commitment to make "no unexpected adverse changes to superannuation." What parts if any of the proposed super reform package will be adopted should become clearer as we get closer to the election date.

Meanwhile, we offer our analysis of the proposed changes:

Limit on tax-free earnings in a super fund in pension mode

From 1 July, 2014, it is proposed that super funds will be limited to claiming $100,000 pa of net income and realised capital gains per pension member as exempt from the 15% earnings tax. This cap will be indexed in line with CPI in $10,000 increments. With inflation at 3% pa, the first increase in the cap would not occur until 2018.

Currently, if no capital gains were realised over the course of a financial year, a single member super pension fund probably would need to have more than a $2 million balance before it would generate net income of more than $100,000 pa and thus be liable for a 15% tax on the balance over that threshold.

However, because long-term assets being sold can realise significant capital gains in a single financial year, special arrangements will apply for investments purchased before 1 July, 2014:

- For assets that were purchased before 5 April, 2013, this measure will apply only to capital gains that accrue after 1 July, 2024. This gives those who could be affected by this change a **10 year period of grace on existing assets** before it comes into effect.
- For assets that are purchased from 5 April, 2013 to 30 June, 2014, individual super pension members will have the choice of applying this measure to the entire capital gain, or only that part that accrues after 1 July, 2014 (which would protect against a situation in which an investment fell in value shortly after purchase, before recovering later).

Of course, for most retirees, paying some tax on super earnings over $100,000 pa would be a nice problem to have.

Even for the relatively small number of super pension members who would be affected if this were to become law, **superannuation will remain far and away the best tax shelter available**. This is because the average tax rate applying to earnings of super pension funds will still be very concessional. For example, a self-managed super fund with two pension members earning a combined $400,000 pa in net income and realised capital gains (where the capital gains were not grandfathered) would pay 7.5% in tax – less than one-third of the average tax rate on this level of earnings outside super (assuming income and capital gains were evenly split).

And if this measure does become law, there are three strategies which we will employ where appropriate to ameliorate its impact:

1. Splitting superannuation contributions each year with the spouse of the member with the largest super balance;
2. If the regulations allow it, and the amount of the combined income and capital gain warrants it - commuting the pension for a short time before selling an asset, so that the capital gain is taxed at 10% in accumulation mode rather than at the 15% proposed higher rate, and then restarting the pension shortly afterwards; and
3. Selling down an ailing super member's portfolio gradually over two or more financial years to ensure that the $100,000 income limit is not surpassed in the year of death, when all assets in his or her super account have to be sold in order to pay death benefits.

However, because it can be difficult to move superannuation between spouses, this proposal discriminates against couples with uneven superannuation balances, and against currently retired couples where superannuation is held solely in the name of one spouse. To this extent one might consider this to be a retrospective tax on stay-at-home mothers. A simple fix to this discrimination would be to combine earnings for couples, as is done for determining age pension entitlements.

There is also a real question as to whether this proposal has been thought through sufficiently by the Government, as there would be significant administrative problems with:

- Unitised super products correctly pricing units owned by pensioners to reflect increases in the value of those units where some gains would be tax-free and some would be taxed at 15%; and
- Managed funds owned by SMSFs, because it would be necessary to identify proceeds from the sale of grandfathered assets and assets subject to the new rules, so accurate tax liabilities can be determined.

The question also arises as to whether the Government would seek to combine the income earned by super pension members in two or more funds. If this were the case, there would be great administrative complexity for the superannuation industry to contend with; whereas if this were not the case, then there would be an obvious loophole in that super pension members with large balances could roll over their assets to several funds to stay under the threshold.

Higher Concessional Contributions Cap for Those Over 50

The Government has not kept its promise to restore the $50,000 concessional contributions (generally employer contributions) limit for those over 50 with a super balance of less than $500,000. However, the proposal to lift the $25,000 annual cap to $35,000 from 1 July, 2013 for those over 60 and from 1 July, 2014 for those over 50 is a step in the right direction.

Unfortunately, this new limit will not be indexed, so the current $25,000 pa cap for everyone is expected to catch up to the higher limit by 2018.

Hopefully, the new Government in its first term will be able to restore the indexed $50,000 pa cap for those over 50.

Those over 60 should not make the mistake of acting on this proposal and contributing more than $25,000 in concessional contributions next financial year, until it has become law.

Extending the Normal Centrelink Deeming Rules to New Account-based Super Pensions

It is proposed that the deeming rules will apply to all income paid by account-based pensions commenced after 31 December, 2014. **The good news is that existing account-based super pensions will remain concessionally treated under the Income Test.**

This new rule is manifestly unfair, mainly because it will target age pensioners with limited assets, but also because it will violate the time-honored principle that because super pension members draw down on their capital over time (if only because of increasing minimum pension levels as they get older), they have always been allowed a capital deduction from the income received. This deduction is calculated by dividing the initial account balance of the pension by the person's life expectancy at the time.

With deeming rates currently at 2.5% and 4%, thankfully only a limited number of single pensioners who have assets totaling between approx. $136,000 and $252,000 (other than their home) and pensioner couples who have assets totaling between approx. $202,000 and $326,000 (other than their home) will be affected adversely – and then only by a relatively small amount, no more than approx. $40 a fortnight.

This is because singles with assets above approx. $252,000 (other than their home) and couples with assets above approx. $326,000 (other than their home) will continue to have their pensions determined by the Assets Test, which is the stricter test above those thresholds.

However, when the deeming rate rises in future years as interest rates increase, the number of age pensioners adversely affected by this measure will expand and the cuts to their age pensions will be greater.

So if this proposal becomes law, super members in accumulation mode who are likely to qualify for the age pension when they reach the required age and are 55 or older will need to consider whether to start an account-based pension or a transition to retirement pension earlier than they had planned, in order to take advantage of the grandfathering rules.

Fairer Treatment for Excess Concessional Contributions

From 1 July, 2013, the Government proposes to allow individuals to withdraw any excess concessional super contributions. These excess concessional contributions will be taxed at the individual's marginal rate (plus an interest charge to recognise that the tax on excess contributions is collected later than normal income tax), rather than at the top marginal rate of 46.5%.

However, the Government has overlooked the unfair treatment of excess non-concessional contributions (after –tax personal contributions). Currently, these excess contributions are taxed at the top marginal rate ignoring the fact that this is already-taxed capital.

Deferred Lifetime Annuities Obtain Favorable Tax Concessions

From 1 July, 2014, the Government proposes to give deferred lifetime annuities the same concessional tax treatment as account-based super pensions. As these products are made available by fund managers, this will enable investors to address longevity risk by purchasing, for example, a deferred income stream at age 60 with a lump sum of say just $10,000, which would start paying an indexed pension of approx. $8,000 pa at age 80 for as long as the annuitant lived.

Double Contributions Tax for Higher Income Earners Confirmed

Legislation has not yet been introduced, let alone passed, but the Government has confirmed its intention to double the tax payable on concessional super contributions from 15% to 30% for individuals who earn $300,000 pa or more, as of the 2012-13 financial year.

In this case, income is defined to include taxable income, concessional super contributions (both employer and salary sacrifice), adjusted fringe benefits, total net investment losses, tax-free foreign income, tax-free government pensions and benefits, less child support. If the $300,000 income limit is exceeded due to concessional super contributions, the 30% tax rate would be applied only to the contribution amount that exceeded the limit.

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