Go-To Guide

$1.6 million
Transfer Balance Cap

SMSF Association
Technical Team

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Key Advice Issues

Transfer Balance Cap

From 1 July 2017 superannuation fund members will be subject to a $1.6 million transfer balance which limits the tax exemption for assets funding superannuation pensions.
Amounts in excess of the lifetime cap will not attract the tax exemption for earnings from assets in retirement phase and will be required to be held in the accumulation phase and taxed at 15%.

Credits and Debits for the cap

- For people with existing superannuation income streams, the total value of an individual's superannuation interests supporting income streams at 30 June 2017 will count towards their $1.6 million transfer balance cap.
- The cap operates on the basis of "credits" counting to the cap and "debits" removing value from the cap.
    - Credits will be created by:
        - the value of super interest supporting income streams on 30 June 2017,
        - commencement of new superannuation income streams from 1 July 2017 onwards,
        - the value of reversionary income streams when an individual becomes entitled to them, and
        - notional earnings accruing to excess transfer balance amounts.
    - Debits will be created by:
        - commutations of superannuation income streams,
        - structured settle payments contributed to superannuation, and
        - certain payments arising from family law splits, fraudulent or void transactions.
- Partial commutations will not count towards a person's minimum drawdown requirements under the new rules.
- Investment gains and losses do not alter the transfer balance cap. Income stream payments do not change the transfer balance cap either.
- Reversionary pensions will count towards the cap, but taxpayers will have a 12 month period to deal with the reversionary pension before a credit arises and counts towards their cap. A similar deferral applies to individuals who are receiving a reversionary pension on 30 June 2017 with the 12 month period commencing on the date of death of the initial pensioner.
- Pensions which are commenced with lump sum death benefit proceeds count towards the beneficiary's cap on the date that they begin being paid to the beneficiary.

Exceeding the cap

- Breaches of the cap will require the excess amounts to be removed which will most likely necessitate partial or even full commutation of the relevant income stream which has exceeded the cap.
- The ATO will issue a notice that the transfer balance cap has been exceeded which will identify the excess.

- If the excess is rectified then the taxpayer only needs to notify the ATO that corrective action has occurred. If not, the ATO will provide 60 days to reduce the transfer balance cap by the excess amount.
- After 60 days the Commissioner of Taxation will issue a commutation notice setting out the amount an income stream must be reduced by to the trustee of the fund. A fund has 60 days to comply with the commutation notice.
- If the commutation notice is not complied with, then the entire income stream will not be eligible for the tax exemption for earnings from assets supporting an income stream.
- Excess amounts will also attract "notional earnings" which count towards the transfer balance cap. Notional earnings are charged at the 90 day bank accepted bill rate plus 7%.
- An excess transfer balance tax of 15 per cent applies to the notional earnings. After receiving one excess transfer tax determination, a tax rate of 30 per cent applies to any excess transfer balance tax assessments the individual receives in a subsequent financial year.

Indexation of the cap

- The transfer balance cap will be indexed in line with the Consumer Price Index and increased in $100,000 tranches.
- Individuals will only be able to access a proportion of the newly indexed amount consistent with the unused proportion of their transfer balance cap rather than the full $100,000 increase when it is available.

Child recipient of a death benefit pension

- A child receiving a superannuation death benefit income stream will have a modified transfer balance cap which is linked to their deceased parent's cap.
  - If a child is receiving superannuation income streams as a child recipient when these amendments begin to apply, the child's transfer balance cap is $1.6 million.
  - If the deceased parent did not have a transfer balance account at the time of their death (i.e. they had not yet entered retirement phase), and they die on or after 1 July 2017, the child's cap is their proportionate share of the deceased's superannuation interests multiplied by the $1.6 million transfer balance cap.
  - If the deceased person had an existing transfer balance account, an adjusted calculation is used to determine the child beneficiary's transfer balance cap, on a proportionate basis if there is more than one beneficiary.

Non-commutable income streams

- "Capped defined benefit income streams" have special rules for the transfer balance cap recognising their non-commutable nature. These modifications apply to lifetime pensions/annuities, life expectancy pensions/annuities and market-linked pensions/annuities.
- Lifetime pensions and annuities have a transfer cap credit value determined by multiplying the annual entitlement by a factor of 16.
- An individual's annual entitlement to a superannuation income stream is worked out by reference to the first payment the individual is entitled to receive after the valuation is required.
- The first payment is annualised based on the number of days in the period to which the payment refers.

- The explanatory memorandum uses this formula to explain this calculation:

$$\frac{first\ payment}{days\ in\ period} \times 365 = annual\ entitlement$$

- Subsequent increases to the income stream benefit relative to the first payment due to indexation are not relevant to the calculation of the annual entitlement

- Life expectancy pensions/annuities and market-linked pensions/annuities have their transfer cap credit value determined by multiplying the annual entitlement by the remaining term.

- The following table from the explanatory memorandum lists the different approaches for valuing these income streams for the transfer balance cap.

Product	*Product definition*	*Special value*	*Debit value*
Lifetime pensions	SISR 1994 subregulation 1.06(2)	Annual entitlement multiplied by 16	Starting special value less previous debits
Lifetime annuities	SISR 1994 subregulation 1.05(2)		
Life expectancy pensions	SISR 1994 subregulation 1.06(7)	Annual entitlement multiplied by remaining term	Special value at the relevant time
Life expectancy annuities	SISR 1994 subregulation 1.05(9)		
Market-linked pensions	SISR 1994 subregulation 1.06(8); and RSAR 1997 subregulation 1.07(3A)		
Market-linked annuities	SISR 1994 subregulation 1.05(10)		

- Where the value of a capped defined benefit income stream exceeds the transfer balance cap, it will not give arise to excess transfer balance tax but instead will attract additional income tax on the income stream.

- Additional income tax consequences are determined in reference to a taxpayer's "defined benefit income cap" which is worked out by dividing the current financial year's general transfer balance cap by 16 (i.e. a cap of $100k in 2016-17).

    - Taxed element or tax-free defined benefit income that exceeds the DB income cap – 50% of the amount exceeding the defined benefit income cap is included in assessable income.

    - Untaxed elements defined benefit income cap is not eligible for the 10% tax offset and is assessable at the taxpayer's full marginal rate.

- When applying the defined benefit income cap, for taxpayers with multiple tax components the following order applies to counting the components to the cap:

    1 – tax-free component
    2 – taxable component – taxed element
    3 – taxable component – untaxed element

- Draft regulations released by Treasury on 16 December 2016 allow for limited commutations of generally non-commutable annuities and pensions (such as market linked pensions) to comply with the transfer balance cap and avoid extra income tax.

    - The partial commutation of these non-commutable annuities/pensions is limited to the amount required to be commuted to comply with the transfer balance cap.

Transitional provisions

- For fund members with retirement income streams at 1 July 2017, they can exceed the transfer balance cap by up to $100,000 without penalty if the excess is reduced within 6 months

Removal of the segregated ECPI method in certain circumstances for SMSFs

- Taxpayers with in excess of $1.6 million in superannuation will be required to use the unsegregated method to calculate the tax their fund must pay on earnings when they have assets in retirement phase and assets in excess of $1.6 million.

Roll-over of death benefits

- The transfer balance cap amendments also introduce the ability to roll-over death benefits from one superannuation fund to another.
- This allows death benefit dependants who are a recipient of a superannuation death benefit as an income stream to transfer the death benefit to another superannuation fund that better suits their needs.
- A consequence of this amendment is that the notion of the prescribed period for death benefit commutations being treated as a super death benefit is repealed.
- This change means that all benefit withdrawals stemming from a death benefit income stream will be treated as a death benefit no matter when the withdrawal is made.
- This will also stop death benefit income streams being able to be commuted and rolled into accumulation phase or being combined with the recipient's member benefits. These amounts will always remain death benefits.

CGT relief arrangements for asset transfers

- The Government has allowed CGT relief for assets that need to be transferred from retirement phase to accumulation phase due to the $1.6 million transfer cap and changes to transition to retirement income streams.
- The CGT relief arrangements will allow funds to reset the cost base on CGT assets that are moved or reapportioned from the retirement phase to the accumulation phase from 9 November 2016 until prior to 30 June 2017.
- This will ensure when the assets are sold, only tax is paid on capital gains accruing after 1 July 2017.
- For segregated current pension assets:
    - Assets transferred from retirement phase back to accumulation phase to comply with the $1.6 million cap will be taken to be disposed of and reacquired on the day of being transferred.
        - This effectively washes out any capital gain accrued up to that point.
    - If a fund is required to change from segregated to unsegregated method as it has a member with a total superannuation balance over $1.6 million, and a member in retirement phase, then all assets are deemed to have been disposed of an reacquired just before this change occurs.
    - Election for this treatment is made via the fund's annual tax return.

- For unsegregated current pension assets:
    - For funds using the proportionate method to determine ECPI, they can choose to apply the transitional treatment to assets.
    - The treatment for unsegregated assets deems an asset to be disposed of and reacquired just before 1 July 2017.
    - As the fund's assets are partly taxable if there is an accumulation component, a taxable capital gain will arise from the deemed disposal and acquisition. This capital gain can be deferred to a later time when the asset is sold.
    - The net capital gain after applying the CGT discount and ECPI percentage for 2016-17 is deferred from being assessable income until the asset is sold. When the asset is sold the deferred gain will form part of the fund's assessable income.
      (The deferred gain is not subject to the CGT discount and ECPI treatment in the year it is brought to account as those elements would already have been applied in 2016-17).

Transfer Balance Cap Case Studies

1 July 2017 Start Date for New Transfer Balance Cap

Example 1

Dave had an SMSF account balance of $1.45 million when he commenced his pension on 1 July 2015. Despite drawing down a pension since then, his account balance at 1 July 2017 has increased and he now has a balance of $1.82 million.

Dave will need to transfer $220,000 back to accumulation phase or pay it as a lump sum benefit by 1 July 2017 to avoid being liable for excess transfer balance cap tax.

Example 2

Dave has an account balance of $1.45 million at 1 July 2017 which supports a pension which commenced prior to that date. Dave is within the new Transfer Balance Cap limits and so can continue his pension without modification.

By 1 July 2019, despite drawing down his pension, Dave's account balance supporting his pension has increased due to good investment performance of his portfolio to $1.82 million. The increase in his SMSF account is not treated as a Transfer Balance Credit. Dave does not have to transfer any part of his SMSF pension account to accumulation phase.

Commutation versus Pension Payment

Sarah, aged 66 years old, commenced a pension in her SMSF on 1 July 2017 with an account balance of $1.2 million. At the time, she elected to receive an annual pension, payable monthly, of 5% of her account balance.

In December 2017, Sarah decided to purchase a new car for $45,000 and chose to access her superannuation account to pay for the car. She partially commuted her pension account and paid herself a lump sum of $45,000. This commuted amount is treated as Transfer Balance Debit and so reduces her Transfer Balance Cap to $1.155 million.

If on the other hand, she had elected to increase her pension by $45,000, her Transfer Account Balance would not have been debited by the additional pension payment.

The partial commutation does not count towards satisfying Sarah's minimum annual pension drawdown requirement.

Spouses with Uneven Account Balances

Joe and Gina have been living together in a de facto relationship for 20 years. Joe has accumulated significant amounts of superannuation and at 31 December 2016, his SMSF account balance is $2.1 million. Gina, on the other hand, had taken considerable time off paid employment to have and look after their children. When she was working, she was paid considerably less than Joe.

Consequently, her SMSF account at 31 December 2016 is $320,000.

Neither Joe nor Gina have made any non-concessional contributions into their SMSF. They are both 62 years of age and are considering retirement and commencing pensions in the near future. Consequently, they wish to maximise the total pension amounts available to them as a couple.

Under the new Transfer Balance Cap rules, Joe's account will be assessed separately to Gina's at 1 July 2017, to determine if he has an Excess Transfer Balance amount. Their combined account balances will not be assessed against a combined Transfer Account Balance of $3.2 million.

Joe could therefore pay a lump sum benefit of $500,000 to himself in order to reduce his SMSF account balance to $1.6 million before 1 July 2017 in order to comply with the new Transfer Balance Cap rules.

Joe can also make a spouse contribution of $500,000 for the benefit of Gina's account within the SMSF using the non-concessional contribution cap bring forward rule before 1 July 2017. Gina's increased account balance of $820,000 is well within her Transfer Balance Cap and so both she and Joe can commence pensions using their full account balances.

Reversionary pensions

When Joe commenced his pension, he nominated Gina as his reversionary pensioner. Gina also nominated Joe as the reversionary pensioner on her pension.

Two years later, Joe is tragically killed in a car accident, and at this time the transfer balance cap remains at $1,600,000. His own Transfer Benefit Cap at that time was $1.71 million which reflected his pension account balance in his SMSF at that time. His pension reverted to Gina who commenced to receive the pension in her own name.

As Gina had already commenced a pension herself at the same time as Joe using her SMSF account balance of $820,000, her Transfer Balance Cap available to her was $780,000.

Gina has 12 months to adjust the reversionary pension she has received as a result of Joe's death before the reversionary pension will be treated as a Transfer Balance Credit. She would need at or before that time, to transfer back to accumulation phase the excess of the total of her personally accrued account balance pension that is over her Transfer Balance Cap of $1.6 million and elect to take some or all of the reversionary pension amount as a lump sum benefit.

Reversionary pensions versus Pensions commenced under a Binding Death Benefit Nomination

In the above example, however, if Joe had elected to execute a Binding Death Benefit Nomination in favour of Gina to receive a pension on his death, the result would be very different.

On Joe's death, Gina would be entitled to receive a pension that would count towards her Transfer Balance Cap immediately on commencement. This would cause Gina to have an Excess Transfer Balance Amount of $930,000 (based on the figures in the above example).

Gina will accrue Excess Transfer Balance Tax until such time as the Commissioner of Taxation issues an Excess Transfer Balance Determination and a Commutation Authority has been issued to the SMSF. The

SMSF has 60 days to comply with the Authority and pay a lump sum benefit of the excess identified in the Commutation Authority.

In this scenario, if Gina wishes to retain some of the excess amount in superannuation, she needs to follow a complex process. If Gina commutes her own pension account, she will create a transfer balance debit of $820,000 (her pension balance as at that time). She can elect for $1,600,000 to be used to commence a pension with the death benefit proceeds, but $110,000 must be paid out as a lump sum death benefit.

If Gina's pension account was greater than $820,000, such as $920,000 for example, the transfer balance debit of $920,000 would have left her with a debit balance of $100,000. This would allow her to use $1,700,000 of the death benefit proceeds to commence a pension, and she would be required to pay out $10,000 as a lump sum death benefit.

In both examples, Gina would retain an accumulation balance as a result of her commuted pension account.

If Gina had not taken these complex actions, she would not have had the option of leaving the excess amount she has received as a consequence of Joe's death in the superannuation system.

If eligible, she may be able to contribute some of the amount back into superannuation under the contribution cap rules. Given her circumstances, this is not a likely option since her total account balance exceeds $1,600,000 and she is therefore in eligible to make personal non-concessional contributions.

Both Joe and Gina would be better off making their pensions reversionary to each other rather than using a Binding Death Benefit Nomination to direct their superannuation to each other on death.

SMSF transfer balance cap checklist

- [ ] Does the fund member understand that the transfer balance cap will limit the amount of tax-free assets that can support a pension from 1 July 2017?

- [ ] Will the fund member have a superannuation income stream in existence on 30 June 2017?

- [ ] Is the income stream an account based pension, a lifetime pension/annuity, a life expectancy pension/annuity or market linked pension/annuity or does the individual have a mix of these pensions?

- [ ] If they have an account based pension the value of the assets supporting the pensions will be a credit towards the individual's $1.6 million transfer balance cap.
  - ⇨ Does the trustee have accurate and up-to-date valuations for assets supporting their pension?
  - ⇨ If the value of assets supporting the pension exceed $1.6 million, action will be needed to reduce the amount of assets supporting the pension via partial commutation.
  - ⇨ Excess assets can be retained in accumulation phase and taxed at 15%.
  - ⇨ There is a six month grace period for excess amounts under $100,000.

- [ ] If the pension is a lifetime pension/annuity then the credit counted towards the cap is the *annual entitlement* x *16*.
  - ⇨ If the value exceeds $1.6 million, reflecting the non-commutable nature of the pension, there will be additional income tax consequences.

- [ ] If the pensions is a life expectancy pension/annuity or market linked pension/annuity then the credit counted towards the cap is *the annual entitlement* x *remaining term*.
  - ⇨ If the value exceeds $1.6 million, reflecting the non-commutable nature of the pension, there will be additional income tax consequences.
  - ⇨ Draft regulations propose to allow limited commutation of these pensions to the extent needed to avoid exceeding the transfer balance cap.

- [ ] Is the fund member receiving a reversionary pension?
  - ⇨ If so, the value of assets underlying the reversionary pension will count towards their transfer balance cap.
  - ⇨ Individuals receiving a reversionary pension at 30 June 2017 will have a period of up to 12 months from the date of death of the original pensioner to deal with the pension before the credit counts towards their transfer balance cap.

- [ ] Will the fund member need to transfer assets from a pension to accumulation phase to comply with the cap?
  - ⇨ Yes – then CGT relief is available for transactions occurring from 9 November 2016 until 30 June 2017.

⇨ CGT relief treatment differs according to whether the asset is currently subject to segregated or unsegregated ECPI treatment

☐ Does the SMSF have a member with in excess of $1.6 million total superannuation balance and a member in retirement phase?

⇨ Yes – then the fund must use the unsegregated asset method to claim ECPI.

This is not an exhaustive checklist for the $1.6 million transfer balance cap. Other issues that may need to be considered include:

- Estate planning:
  - regarding how reversionary and non-reversionary pensions count towards the transfer balance cap , and
  - the treatment of child death benefit pensions under the cap.
- How superannuation assets can be split between spouses to best utilise the $1.6 million transfer balance cap.
- Planning for pensions that commence post 1 July 2017.
- Consequences of excess transfer balances.

White Label Document

Click here to download the $1.6 million transfer balance cap white label document