The SMSF Academy Podcast - Transcript

Episode	27
Topic	Impact of changes to partial commutations
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Aaron Dunn: You're listening to The SMSF Academy podcast. This is Episode 27.

Speaker 2: Welcome to The SMSF Academy podcast, the show designed to help professionals stay ahead of the curve. Now, here's your host, the man that's in the know and shows you how SMSF is done right, Aaron Dunn.

Aaron Dunn: Hi there and thanks for joining me in this week's episode of The SMSF Academy podcast. As we move closer to Christmas, there is still plenty of stuff to work through and in this week's topic, we're going to be looking at partial commutations because we have seen quite significant changes in the way in which partial commutations operate within our SMSF client base. In particular, some of the key strategies that we had available to us prior to the introduction of these reforms on the July 1, 2017, means that we have to, now, revisit partial commutations in an entirely different way. Most importantly, there is a greater focus on partial commutations, in particular, now, around the introduction of the transfer balance cap and where those partial commutations create a debit against the member's transfer balance account.

Before we move into that, let's just go back and really have a look at why partial commutations pre the superannuation reforms were a very useful tool to do. Because what we did see is that we had the opportunity, in many respects, to have this regulation, 995.103 (ITAR 1997) election apply. Whether it was across an account based pension or whether it was through a transition to retirement income stream. In both of those circumstances, the tax laws actually allowed for us to recharacterise what was a pension benefit coming out of a superannuation income stream to not be a superannuation income stream benefit, but rather a lump sum for income tax purposes. What that ultimately meant was, for an individual who was under the age of 60, it meant that that individual could have the amount tested against their low rate cap, which in that 2016/17 year was $195,000.

This was a very popular way, rather than having the pension payment attributable to that individual as assessable income, and therefore, sure, they got the 15% tax offset, but they could, in essence, have that entire amount assessable to them, but if they had not used any of that unused cap, well, they had available space left with their low rate cap, in essence, that amount was rebated back to them, so there was no tax consequence in doing so. That was certainly something very popular and we saw that extended, in particular, without transition to retirement income streams as well and many people even looked at introducing that strategy as part of the 2016/17 year for clients to even qualify for the CGT relief around TRISs, but not have any major tax implications on that particular member because they may have already been on a much higher tax rate.

The other key area that was available here, and this is where the ATO previously had put guidance out around commutations within tax ruling, TR 2013/5 around when a pension commences and ceases. At the same time that that ruling was issued by the ATO, we saw self-managed super fund determination, SMSFD 2013/2. What the ATO said within that determination was, because the pension does not cease, the requirements of that benefit was whether we actually took that benefit as a pension or a lump sum, did not preclude the fact that it would actually satisfy the minimum pension obligations for that income year. What that was really important to achieve for our clients was the fact that when we have pension benefits, pensions can only be paid by way of cash. Therefore, when we wanted to make a lump sum payment, lump sums allow us to make a payment in cash or in kind, i.e. as an in specie transfer. That in specie benefit therefore, meant by

virtue of qualifying for the minimum pension in that particular income year, it meant that we could do these ‘quasi’ in specie pension payments.

Ordinarily, we couldn't do an in-specie pension payment by operation of the law, but where we made this election to do so and treat the amount as a lump sum, and the fact that we had the guidance around SMSFD 2013/2, it meant that that lump sum payment, as an in-specie transfer, would qualify for the minimum (pension) and again, provided a fantastic outcome for our superannuation members. Now, when we move forward to the July 1, 2017, as part of these budget measures, the government has now tidied up both of these two key areas. First and foremost, we've seen a straight repeal of that regulation 995.1.03 of ITAR 1997 that no longer allows for a fund to choose to elect to recharacterise that particular payment. What the flow on effective that also means is that if we have no ability to recharacterise that as a lump sum, we now no longer have the ability to have these amounts treated as an in-specie benefit payment.

Importantly then, if we want to enable the transfer of an asset out of the superannuation fund, we will have to, now, first, roll that money back into the accumulation phase and ensure that that lump sum payment has come out of the accumulation interest of the member, not from the retirement phase income stream of that particular member. The other change that we've seen as well impacts that previous determination TD 2013/2 and the ATO has noted on that ruling that it is subject to review at the moment as a result of the superannuation reforms because we have seen the government, again, make an amendment to SIS Regulation 1.07D. What the regulation now incorporate here is that the commutation requirements of the superannuation income stream will mean that when we have a commutation that actually occurs or takes place in that year, it will ensure that it no longer counts towards the minimum pension obligation for that particular income year.

Therefore, it means that if we have a commutation or a partial commutation occurs, and we may pay out a benefit, let's say, it's $50,000 and the fund had an amount of $55,000 for the year (to be paid), it no longer means that we have $5,000 worth of benefit remaining towards the minimum pension for the year. The member would still need to take an additional $55,000 for the rest of the income year to ensure that it satisfied the requirements of SIS Regulation 1.06(1) and 1.06(9A) in particular for account based pensions. That, again, is a very important shift in respect to the way in which commutations have occurred. We've now made the changes inside our partial commutation documentation and we've, in essence, now created a line in the sand at June 30, 2017, so based upon what period of time you're documenting that decision, whether it's a pre-July 1, 2017 commutation or whether it's a post-June 30, 2017 commutation, it will ensure that you can answer those specific questions and then document those decisions accordingly.

Now, with these new rules though, of course, partial commutations, in my view, are going to substantially increase in their use. First and foremost, whereas we see clients taking their pension benefits out in the past, we haven't really had to worry in terms of the form in which they were taking pension benefits. I.e., the fact that someone was over 60 years of age and if they took a large amount out as long as it was tax free in their hands, we didn't really care what that result was, but for the fact that if they had multiple pensions, we may have been looking at whether it came out of, one income stream or the other subject to have caused that we've met that minimum pension obligation. Now however, there is clearly a greater focus on how we are going to be taking benefits out where that individual is taking more than the minimum pension for that particular year.

In some of our recent training and discussions, we've spoken about that prioritisation of cashing, in so far that, (a) we want to ensure that we've taken the minimum pension, (b)

we want to look at whether we need to take benefits out of an accumulation interest of a member if they do, now, have an accumulation benefit in the fund as a result of the introduction of the transfer balance cap. They may have rolled some of that money back to the accumulation phase. Therefore, we would be, as a second point, looking to take money out of the accumulation interest to try and improve the tax exemption inside that fund again for the remainder of that year and subsequent income years. Then finally, what we're looking to do is then trigger partial commutations. This partial commutation is going to be important because as pension payments, we don't get the ability to have a debit against that member's transfer balance cap.

Where we have a husband and wife situation, from an estate planning point of view where the combination of those two amounts is greater than the transfer balance cap, the fact that a member's transfer balance account dies with them and doesn't carry across to that surviving member means that we need to start thinking now and planning out, from an estate planning point of view, how we might be able to reduce the value of that initial credit that is being applied by one or more income streams. Therefore, those above minimum payments may be worthwhile, rather than treating as pension payments to partially commute that income stream because of course, they're going to get a debit against their transfer balance cap. We have some initial guidance, going back to TR 2013/5 around what is a commutation when we look at it by its definition, but more importantly, when we look at the practical compliance guidance (PCG 2017/5) that was issued by the ATO in the lead up to June 30th around the transfer balance cap, we have a very clear framework that actually outlines what we are required to do in the commissioner's eyes to ensure that we actually have a valid commutation.

Many of you would've been documenting commutations in part or in full in the lead up to the 30th of June around the individuals that needed to comply with the transfer balance cap or in some respects, with the TRIS reforms. What the ATO said within that PCG 2017/5 is that:

- We needed to have those decisions ultimately requested by the member and accepted by the trustee, both being made in writing. This could be a documented trustee resolution.
- They needed to be done before July 1, 2017.
- They needed to be prospective in the way in which they were drafted.

Importantly, and I still say people at the moment, documenting this decision now, you are putting into question the ability for things like (applying) CGT relief because it required that process to be done before July 1, 2017.

We then needed to:

- specify a methodology that allowed for that precise quantum of the commutation to be calculated, which could've been done at a later time with our super reform measures coming in, it is going to form part of being done with the completion of the tax return.
- to specify the income stream, which will be subject to the commutation. That request could've caused to have a more than one income stream, but it needed to deal with the priority in how those commutations would occur.
- not conflict with any other agreement to commute that the member has subsequently put in place or put in place with the trustee of a different superannuation fund.

That has provided us with a really important framework moving forward around how we're going to deal with benefit payments. When we think of partial commutations post July 1,

2017, in my view, it's going to be a really important requirement as part of the annual pension review requirements that if you are looking to trigger partial commutations that you are putting in place, the appropriate building blocks that are consistent with what the ATO has already issued as guidance in that PCG 2017/5. We want to ensure that:

- there is a member request and trustee acceptance and that process has been done and has been made in writing.
- It has been done before the payment has been made (the ATO made reference to the introduction of the new measures, in this instance, we're looking at it in a prospective basis);
- you specify the methodology that allows for the precise quantum of that amount to be commuted, i.e., that would occur at some future point in time when the member has decided in terms of what benefit they're going to be taking and
- it specifies the income stream from which that commutation is to occur.

Again, we would be looking at this from an estate planning point of view, in particular, in respect to which income stream we want to take it upon looking at, arguably, the one with the highest taxable component first. So, we have this predetermined framework that we need to ensure that we do and then when we get to that point in time where the commutation occurs, we then would, of course, document that accordingly, in so far that we have already put in place our initial requests that have the agreement by the trustee off the member's request; now, the trustee confirming that payment and then notification to that member that the commutation has occurred, which would also include, of course, the transfer balance cap reporting, which would be a debit against that member's transfer balance account.

Subject to the timing of that, we're either looking at the concession that exist in the current year to the July 1, 2018, or from July 1, 2018, we have this $1 million dollar threshold that we need to consider on a member's total superannuation balance to work out whether the fund needs to do it (report) on an annual basis or 28 days after the end of the quarter.

There are some really key differences that, now, we are seeing around partial commutations. Life was pretty good with the partial commutation rules prior to July 1, 2017. There were certainly some fantastic opportunities around, not only transition to retirement income streams, but around income streams more generally where we could make those in-specie pension payments, have them count towards the minimum pension, use them against low rate caps and much, much more.

It is important to remember that those changes are now in effect from July 1, 2017. Therefore, we need to ensure that you, not only understand those rules but document those decisions in line with the changes to those measures. In particular, the repeal of regulation 995.1.03 and also, around regulation 1.07D, which ensures that that commutation no longer counts towards the minimum pension and use the guidance that the ATO has already provided us within PCG 2017/5 around how we should be documenting these partial commutations - In particular, around benefits where the member is intending on taking more than their minimum from their superannuation income streams for the income year.

Like I said, we've made some pretty substantial changes into our partial commutation suite inside our campus platform, which are available, not only for our silver and gold members, but if you wish to utilise on a pay-as-you-go basis, you can do so as well. Simply sign up under our free or paid to go membership and you can then order those as and when you need them.

If you do have any other questions, please feel free to reach out to me at info@thesmsfacademy.com.au or you can find us through our various social media channels. Thanks for joining me today for SMSF Academy podcast. I look forward to discussing next week's topic with you. Until then, bye for now.

Speaker 2: Thanks for listening to The SMSF Academy podcast. Please note that the podcast provides general advise only and is based upon our understanding of the law at the time of the recording. If you have any comments or questions from this podcast or wish to subscribe to the series, you can find us at thesmsfacademy.com.au. Tweet us at The SMSF Academy. Like us on Facebook or connect with us on LinkedIn.