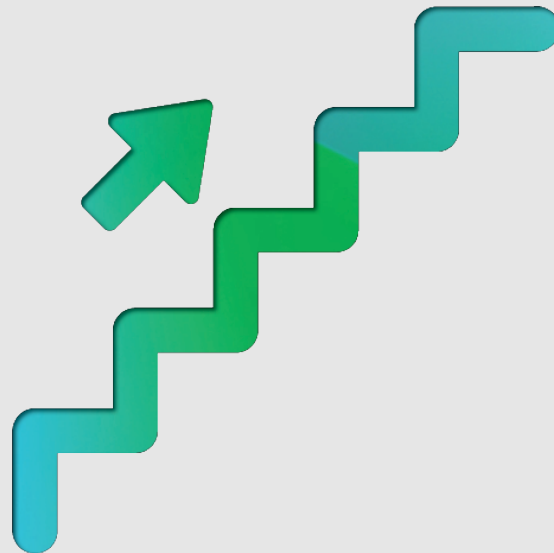


# Next super steps

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See annuities differently	Repatriation of foreign pension funds	Managing CGT in and out of super	Death and passing on benefits tax effectively
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As we begin a new decade, our superannuation environment remains just as complex. With more than three decades of super asset growth behind us, this guide explores four super strategies that are designed to elevate your superannuation advice into the next decade.

## Contents

See annuities differently _____	4
Repatriation of foreign pensions funds _____	16
Managing CGT in and out of super _____	22
Death and passing on benefits tax effectively _____	29

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# Next super step: See annuities differently



## Next super step: See annuities differently

### What is an annuity?

Essentially, an annuity is a product that allows the purchaser to exchange a once off cash lump sum for a regular stream of income payments over the selected term into the future. It is effectively using a lump sum to buy a known and guaranteed income stream into the future. This future income stream, and under certain contracts the return of all or part of the purchase price, is guaranteed by the product provider irrespective of how investment markets and interest rates perform. In this way, an annuity can provide a degree of certainty and security to future cash flow requirements.

In Australia, annuities are provided primarily by life insurance companies and are usually paid from the life office's statutory fund. Life offices themselves are regulated by the Australian Prudential and Regulation Authority (APRA) and are required to hold "reserves" and meet solvency and capital adequacy tests to ensure that they can meet all future liabilities.

### Characteristics

The features of the modern annuity product can vary greatly with some of the key features being:

- Funding source can be either superannuation or ordinary money
- Payment terms can be for a fixed term or for life (payable to death)
- Level payments or indexed (based on CPI or within a certain selected range)
- On a single life or reversionary to another
- With a nil residue capital value and no access to capital, to full or partial capital access either during the term or at the end date
- Advantaged assessment of benefits for Centrelink and Aged Care clients

Under a fixed term annuity, the lump sum used to purchase the annuity is returned to the investor either at the end of the term, or alternatively, all or part of the capital can be returned as part of the regular payment over the term of the annuity.

The regular income that is agreed to at the beginning of the contract, plus the return of the original capital, is guaranteed by the product provider regardless of how investment markets and interest rates perform over time and into the future.

Under a lifetime annuity contract, the agreed income stream is guaranteed until the death of the annuitant irrespective of whether they reach their statistical life expectancy or not. This can be extended to include a reversionary beneficiary's lifetime too. Generally, while the original purchase price is returned over the life expectancy term of the investor, there is no access to capital after this point.

Under limited circumstances, "complying" lifetime annuities may be available. Complying usually denotes that the annuity complies with certain sections of the Social Security Act 1991, which can allow it to qualify for concessional Centrelink treatment. Such annuities, particularly those structured under older contracts, are generally non-commutable (except to another similar complying annuity), provide little to no access to capital and lack much of the flexibility discussed above.

### Centrelink treatment post 1 July 2019

The Government's 2016-17 Budget included proposed changes to how lifetime annuities are means tested for Centrelink Asset and Income test purposes. These came into effect from 1 July 2019 for Centrelink purposes. Lifetime annuities purchased before 1 July 2019 are grandfathered.

The new rules are linked to the introduction of the Government's "Comprehensive Income Products for Retirement" agenda, which aims to encourage the use of retirement savings to support individual's retirement needs over their lifetime. The aim is to help the Government manage the increasing cost of providing retirement assistance – age pension – due to increasing life expectancies.

While there are new rules for the assessment of lifetime annuities, there continue to be short and long term annuities available.

## Centrelink's view of annuities

Annuities are classified as "asset-tested income streams" for Centrelink assessment purposes and are divided into:

- Short term:
  - The term of the product when purchased is 5 years or less, and it is not either a long term or lifetime asset-tested income stream (annuity)
- Long term:
  - The term of the annuity is for a specified term of more than 5 years, but not for life, or;
  - The term of the contract is for a specified term of less than 5 years **and** is equal to or greater than the purchaser's life expectancy, or;
  - The annuity pays for the life of an individual(s) and the annuity was purchased before 1 July 2019.
- Lifetime:
  - The lifetime annuity was purchased after 1 July 2019, and;
  - The annuity ensures that, once it starts paying income, it continues to pay for the remainder of the product owner's life, and;
  - The amount of payment considers the age, life expectancy or other factors relevant to the mortality of the product owner.
  - Lifetime income streams purchased before 1 July 2019 are assessed as asset-tested income streams (long term)

## Short term annuity

### Income test

Short term annuities are treated as financial assets and assessed under the deeming provisions.

### Asset test

The asset value of a short term annuity is determined using the following formula:

$$\text{Purchase price} - \left[ \frac{(\text{purchase price} - \text{residue capital value})}{\div \text{relevant number}} \times \text{term elapsed} \right]$$

where:

- Relevant number is the term of the annuity, or in the case of lifetime and life expectancy annuities, it is the life expectancy as shown in the relevant Australian Life Tables published by the Australian Government Actuary
- The term elapsed is the number of years that have elapsed since the annuity's start date. The number of years is rounded down to the nearest:
  - **Half-year:** when the asset value is determined on a 6-monthly basis, or;
  - **Whole year:** when the asset value is determined annually.

### Example

Sally is 65 years old and single. She purchases a 4-year annuity with an RCV of \$20,000 for \$150,000. She receives a total payment of \$18,337 per year. Monthly payments commence on 1 January. Her assessable asset from 1 January for the first 6 months will be:

$$\$150,000 - \left[ \frac{(\$150,000 - \$20,000)}{\div 4 \text{ years}} \times 0 \text{ years} \right] = \$150,000.$$

The following table shows when the asset value is determined for a short term annuity.

How often paid	Asset value is determined
Once per income year	Annually at the start of the contract year
More than once per income year	Twice a year at the start of each 6-month period

## Other things to note

- Where an annuity continues to be paid to a reversionary beneficiary after the death of the primary beneficiary, it will continue to have the same commencement day, purchase price and relevant number
- Where there is a partial lump sum commutation from an asset-tested income stream (annuity), the partial commutation does not change the relevant number of the income stream. The original purchase price, however, is reduced by the actual amount commuted to recalculate the new asset value
- The asset value of a short term annuity can be reduced by a charge or encumbrance secured against it

## Long term annuity

### Income test

Non-account based income streams, including term income streams, receive an income deduction based on the purchase price. The assessable amount is calculated as follows:

$$\text{Annual payment} - [(\text{purchase price} - \text{residue capital value}) \div \text{relevant number}]$$

#### Example

Sally is 65 years old and single. She purchases a 10-year annuity with an RCV of \$20,000 for \$150,000. Her total annuity payment for the first year is \$18,337. Her assessable income from this income stream will be:

$$\$18,337 - [(\$150,000 - \$20,000) \div 10 \text{ years}] = \$5,337 \text{ per annum.}$$

### Asset test

The asset test treatment for a long term annuity is the same as for a short term annuity (see notes and example above).

## Lifetime annuity

The Centrelink assessment of lifetime annuities depends on a number of factors such as age, the use of superannuation or non-superannuation money, and involves understanding three new concepts – assessment day, threshold day and the capital access schedule (CAS).

### Overview

The table below summarises the Centrelink means test assessment of asset-tested income streams (lifetime).

#### Centrelink means test assessment of asset-tested income streams (lifetime)

Type	Asset test	Income test
Purchased with superannuation monies	<p><b>Before</b> the assessment day<sup>1</sup>, there is no assessable asset value.</p> <p><b>On or after</b> the assessment day, but <b>up to and including</b> the threshold day<sup>2</sup>, 60% of the purchase amount is assessed as an asset.</p> <p><b>After</b> the threshold day, 30% of the purchase amount is assessed as an asset.</p> <p>Asset value may be higher if the income stream has a high surrender value or death benefit<sup>3</sup>.</p>	60% of the gross payments is assessed as income.
Purchased with non-superannuation monies	<p><b>Before</b> the assessment day, 100% of the purchase amount is assessed as an asset.</p> <p><b>On or after</b> the assessment day, but <b>up to and including</b> the threshold day, 60% of the purchase amount is assessed as an asset.</p> <p><b>After</b> the threshold day, 30% of the purchase amount is assessed as an asset.</p> <p>Asset value may be higher if the income stream has a high surrender value or death benefit.</p>	<b>Before</b> the assessment day, the purchase amount is a financial investment and the deeming provisions apply; or <b>on or after</b> the assessment day, 60% of the gross payments is assessed as income.

<sup>1</sup>Assessment Day defines when the above income streams are assessed as such by Centrelink – further details below.

<sup>2</sup>Threshold Day is the day the minimum assets test assessment steps down from 60% to 30% of the purchase amount. It is currently set at the later of 84 years of age or, the last day of a five year period beginning on the person's assessment day.

<sup>3</sup>If CAS (see later as defined) not met, the assessable asset value is the higher of a) 60% (up to and including threshold day) or 30% (after threshold day) of the purchase amount; b) the highest surrender value above the CAS value for that or any future day; c) the highest death benefit above the CAS value on that day or any future day.

## New concepts and definitions

### 1 Assessment day

Assessment day is a new concept that defines when asset tested income streams (lifetime) are assessed as an income stream for Centrelink purposes. It is quite complex but for most people, will simply be the date they purchase the lifetime annuity. The tables below provide further details:

#### Non-reversionary beneficiaries

If the asset-tested income stream (lifetime) did not revert to the person as a reversionary beneficiary, and...	Was purchased with superannuation monies,	then the person's assessment day in relation to the income stream is...	The latest of the following: 1. The day the person first satisfies a relevant condition of release 2. The day the first amount was paid for the income stream, and; 3. The day the person acquired the income stream (if no amount is identifiable as having been paid for the income stream).
	Was not purchased with superannuation monies,		The income stream's commencement day, provided the commencement day is before the day the person reaches pension age or; 1. The day the person reaches pension age 2. The day the first amount was paid for the income stream, and; 3. The day the person acquired the income stream (if no amount is identifiable as having been paid for the income stream).

#### Reversionary beneficiaries

If the asset-tested income stream (lifetime) reverted to the person as a reversionary beneficiary, and...	The income stream reverted on or after the income stream's commencement day,	then the person's assessment day in relation to the income stream is...	The day the income stream reverted.
	The income stream reverted before the income stream's commencement day, and was purchased with superannuation monies,		1. The income stream's commencement day, provided the person has not yet met a relevant condition of release. 2. Otherwise, the assessment day is the later of the day the income stream reverted, and the day the person met a relevant condition of release.
	The income stream reverted before the income stream's commencement day, and was not purchased with superannuation monies,		1. The income stream's commencement day, provided the commencement day is before the day the person reaches pension age or; 2. Otherwise, the assessment day is the later of the day the income stream reverted, or the day the person reaches pension age.

## 2 Threshold day

Threshold day is the day the minimum assets test assessment steps down from 60% to 30% of the purchase amount.

While this is currently set at the later of either 84 years of age, or the last day of a five-year period beginning on the person's assessment day, it is based on a calculation that takes the life expectancy of a 65 year old male (rounded down to the nearest whole year) and adds 65.

### Note

Threshold day is based on the Australian Government Actuary Life Table current at the time of calculation and so will change over time. For the period 1 July 2019 forward (until it is updated), the life expectancy of a 65 year old male is 19.22 years. Rounded down this is 19 years. The addition of  $19 + 65 = 84$ .

If the income stream is not a joint income stream, the person's threshold day is the later of the following days:

- The day before the person reaches the age in years worked out under the formula (above)
- The last day of a 5-year period beginning on the person's assessment day
- If the income stream is a joint income stream, the person's threshold day is the later of the following days:
  - The day before the oldest of the joint owners reaches the age in years worked out under the formula (above)
  - The last day of a 5 year period beginning on the person's assessment day

Determining the threshold date for a reversionary is more complex:

- If the annuity reverts after the original annuitant has passed their assessment day, the reversionary beneficiary's threshold day is the same as the original annuitant
- If this calculation results in threshold date prior to the reversionary beneficiary's assessment date, then the

reversionary beneficiary's threshold day is their assessment day

- If the annuity reverts and the original annuitant has not passed their assessment day, the reversionary beneficiary's threshold day is calculated in the same way as if they were not a reversionary beneficiary

## 3 Capital access schedule (CAS)

CAS is a new concept that forms one of the four key elements required for an annuity or superannuation pension to meet the "Innovative Superannuation Income Streams" criteria. Having met all the necessary criteria, these innovative income streams are eligible to receive an income tax exemption on the assets used to support such pensions, and payments from these products will be treated (taxed) as superannuation benefit.

The CAS provides the maximum amount that can be commuted from a lifetime annuity either voluntarily (surrender) or on death. In summary, the maximum amount that can be commuted as a voluntary surrender value is a declining straight line over the primary beneficiary's life expectancy (or reversionary beneficiary's life expectancy in certain circumstances).

On death, the maximum amount that can be commuted is 100% of the purchase price within the first half of the primary beneficiary's life expectancy, then after this date, the declining straight line value applies.

No amounts can be commuted from the income stream once they reach their life expectancy.

Annuities must meet these requirements too in order to receive preferential Centrelink treatment.

The chart on the following page provides a graphic representation of the operation and limits of the CAS.

### Limits for high surrender values or death benefits



## Key strategy insights for annuities

It needs to be clearly understood that the CAS is the maximum amount of capital that can be accessed. Product providers are free to design products that return a lesser amount of capital. For example, the product provider may choose not to allow 100% of capital as a death benefit for the first half of the life expectancy. Instead, they may elect to return an amount based on the declining straight line amount over the beneficiary's life expectancy, or even a lesser amount.

Annuity providers have been quick to highlight the normal advantages that annuities can provide and to be fair, those advantages will probably apply to the majority of potential investors. These include:

- Regular secure payments for life (and your spouse's life if you choose) can be indexed
  - Provides a level of certainty and stability to future cash flows
  - Allows individuals to put a known base cost of living amount in place
- Payments that are guaranteed regardless of how investment markets perform
  - Reduces the potential investment risk – both volatility and potential for capital loss
  - Potentially, greater "peace of mind" for conservative investors
- Centrelink advantages (where eligible) – partially sheltered from the income test (40%) and asset test (40% and eventually going to 70%) thereby providing a higher level of aged pension
  - Less pressure on own capital base – may last longer
  - Enhanced cash flow
  - Access to ancillary benefits – health cards
- Payments that start immediately or can be deferred to a future date you choose
- Product can be (not must be) designed to pay a lump sum death benefit to your family or estate as determined under the CAS
- Product can be (not must be) designed to offer the flexibility to withdraw and pay a lump sum up to the surrender value under the CAS
- You can use your super or personal savings to invest

**Next super step: See annuities differently**

- Payments that are tax free if you use your super to invest and you are aged 60 or over

There are also some potential disadvantages to annuities including:

- A lack of flexibility in comparison to account based pensions
  - With lifetime annuities, access up to 100% of the capital is possible for up to half of the individual's life expectancy for CAS aligned annuities. At that point, it drops dramatically and thereafter is available only on a decreasing straight line capital amount to the statistical life expectancy. At this point, all the capital has been recovered to the individual and no further capital is available to either the individual or their estate
  - They are interest rate sensitive – the return is fixed for the term, including for a lifetime, at the point of purchase
  - They offer no access to (possible) capital growth
  - The annuitant is reliant on cash flow only – not able to access capital lump sums e.g. to buy a replacement motor vehicle
  - Lifetime annuities may provide less flexible estate planning options

## Looking deeper into the use of annuities

### Centrelink benefits explored

#### 1 Asset test

The age pension is reduced by \$3.00 for every \$1,000 of assessable assets over the threshold. Thus, with only 60% of the annuity purchase price assessable the potential benefit – a reduced pension reduction penalty – is:

Strategy	No annuity	Annuity
Pension reduction amount/\$10,000	(\$10,000/\$1,000) x 3 = \$30	[((\$10,000 x 60%)/\$1,000) x 3 = \$18
Improved pension benefit/\$10,000	\$NIL	\$12

#### 2 Income test

The age pension is reduced by \$0.50 per \$1.00 over the threshold. Thus, with only 60% of the annuity income assessable, the potential benefit – a reduced pension reduction penalty – is:

Strategy	No annuity	Annuity
Pension reduction amount/\$100	(\$100 x \$0.50) = \$50	(\$100 x 60%) x \$0.50 = \$30
Improved pension benefit/\$10,000	\$NIL	\$20

#### 3 Observations

- If one is already on the full pension, annuities may provide no financial benefit
- Most useful to those receiving a part pension or at the upper margin of the threshold
- Those who will never qualify for the age pension gain no financial benefit

### Estate planning benefits

It is really only lifetime annuities that can be seen to provide inflexible estate planning opportunities because as the capital has been recovered over the life expectancy, there is nothing left to pass to the estate or beneficiaries.

However, fixed term non-super annuities can provide a range of estate planning opportunities:

- Can be paid straight to another nominated beneficiary(s) bypassing the estate and thereby reducing the chance of a successful challenge to the estate
- Receive regular income, then on death, capital (RCV option) to beneficiary
- Can have regular payment to non-dependant – useful where the beneficiary may be unable to properly manage their financial affairs

- If super money used, the usual dependant rules apply (see above notes).

## Alternative for term deposits

In the current lower interest rate environment, short term 100% RCV (non-super) annuities may be considered as a viable alternative to term deposits. Understanding why is important to understanding how to use this strategy safely.

The return on a short term deposit is based solely on the current interest rate environment.

Annuities, including short term annuities, are paid from the statutory fund of the life company and these pooled funds have often been in existence for many years. As such, they have a portfolio that includes past fixed interest investments that may have been purchased at higher rates, quasi fixed interest instruments that may pay a higher return as well as property and equity investments, all of which contribute to the manager's ability to pay a competitive return. In a low interest rate cycle, this may provide annuities with a competitive advantage.

However, a key question is how long can that last? The statutory fund is actuarially reviewed to ensure it can meet its future liabilities, but the longer the low interest rate cycle lasts and is forecast to last, the more the annuity rates may tend toward the current interest rate position as the competitive investment position is diluted.

Looking forward, when interest rates start to rise, the opposite might be true as the statutory fund may now have a "tail" of past low interest investments. How the annuity provider manages this will determine the impact on the rates they can offer as the interest rate cycle transitions.

## Overseas resident investors

Overseas tax residents of countries with which Australia holds and international tax treaty, are not subject to withholding tax in Australia on annuity payments. This may result in a nil tax impost in comparison to the 15% withholding on other payments like term deposit interest payments. There may be tax implications in the country of residence.

## Aged care

Aged care costs are calculated with reference to the means tested care fee (MTCF). The MTCF is the addition of both assessable income and assets to produce a single dollar amount which is then tested against the aged care thresholds to determine the individual's required contribution toward age care costs. The lower this combined amount is, the lower the individual's contribution requirement will be.

The MTCF arm of the asset test values many assets in the same way that the Centrelink asset test does. However, there are some differences, notably in the treatment of the primary residence and refundable accommodation deposit.

An additional benefit of an annuity is that the reduced asset value – the assessable amounts of 60% and then 30% – are the relevant amounts used for the asset test. For those entering aged care after the threshold date, this means 70% of the annuity value will be exempt, thereby reducing the MTCF.

Similarly, with only 60% of the income stream being assessed as income under the aged care income test, an annuity will reduce assessable income and therefore, can act to reduce the individual's contribution amount to total aged care costs.

In addition to benefits under the aged care MTCF thresholds, an annuity can increase the level of Centrelink entitlements, thereby providing greater cash flow to fund the cost of age care.

## Impact of Capital Access Schedule (CAS) – lifetime annuities

The CAS applies only to lifetime annuities and operates to limit the accessibility to capital to allow it to be used to provide a lifetime pension. However, some access to capital is available as a withdrawal (surrender) amount or a death benefit, as previously explained. Understanding how it operates, reveals a number of interesting points.

Essentially, from the date the lifetime annuity is commenced, the CAS defines the maximum amount of capital that the product can be designed to allow to be recovered by the annuitant over their life expectancy. Upon attaining the life expectancy age, all the capital has been recovered.

## Next super step: See annuities differently

At a simplistic level, the fact that there is no access to capital after life expectancy, to neither the individual nor to the estate, may possibly make these products unattractive. However, advisers need to remind clients, particularly those eligible for Centrelink, that a lifetime annuity does not destroy capital, it simply returns it to them over their life expectancy with interest and could result in an increased Centrelink entitlement.

Also, the payment continues past life expectancy without reduction, despite the full recovery of the original capital to the annuitant. These points are particularly important when comparing the use of an annuity with other options like a term deposit.

As highlighted at the March 2020 Netwealth superannuation roadshow, "Next super steps", the CAS can also give rise to a payment anomaly advisers need to be aware of, particularly when comparing an annuity to a term deposit.

The CAS allows up to 100% of the capital to be repaid to the estate as a death benefit for half of the annuitant's life expectancy. Where the product design and rules allow this, death up to that point means the individual will have received the regular payments consisting of both capital and income, and the estate will receive 100% of the capital. This combination means that total cash received – being annuity payment (being return of capital + interest) to date of death + 100% annuity purchase price at death – is a far more attractive proposition than term deposit alone. At death, a term deposit has simply returned an interest only component and 100% capital repayment.

However, from that date (half-life expectancy point) forward, the annuity death benefit is reduced under the CAS, to be in line with diminished straight line value, eventually reducing to zero at statistical life expectancy. From this point forward, the total received at death – being the regular pension payments (capital component and interest) + diminishing death value – can result in the term deposit being more financially attractive.

But the story does not end there. Under the annuity strategy, even though the estate, after the half-life expectancy point, will get a reduced or zero capital lump sum at death, over the life of the annuitant they are still receiving a significantly greater regular payment – being the interest component + the capital component – in comparison to the term deposit. Given enough time, the

annuity strategy has the potential to at least catch up to the term deposit or even surpass it.

Further, the annuity strategy may result in an increased Centrelink entitlement. When this is added to the equation, the total aggregated return – being annuity payment + increased Centrelink – could significantly reduce the time to reach this equality point. It is possible under the right circumstances, that the annuity strategy may even return a greater amount than the term deposit alone at all points along the investment timeline.

How long this takes depends primarily on the interest rate differential between the term deposit and the annuity, and how long the annuitant lives.

So, the key take-aways from this CAS analysis are:

- The normal lifetime annuity advantages can make a compelling story for those more concerned with stability and certainty of income, rather than either long term access to capital or sensitivity to maximising estate proceeds
- Lifetime annuities repay the capital over time (not destroy) and then keep paying past the point of capital exhaustion, which is normally life expectancy
- The CAS is the maximum amount to which access may be permitted and still qualify as an "innovative income stream" with the associated benefits. However, it is up to the product provider to determine the final product features up to the CAS. Therefore, planners may need to analyse individual annuity product features to ensure the best fit to client's needs
- Annuities may give the individual better cash flow as a result of repaying a portion of the capital and interest within each regular pension payment and, where applicable, a greater Centrelink entitlement
- In comparison to a term deposit, there are three distinct stages over a lifetime annuity's life cycle where the product utilises the CAS to provide varying payment benefits:
  - From purchase to half the individual's life expectancy, an annuity may have a significantly better total aggregated return profile
  - From the half life expectancy point onwards, the CAS reduces the death benefit, resulting in the

## Next super step: See annuities differently

- annuity's aggregated total return probably falling behind that of the term deposit
- At some future point past the statistical life expectancy of the annuitant, the aggregated (capital + interest) income payments generated by the annuity can mean that the total aggregated balance will again match and may even surpass the term deposit alternative
- If the strategy results in additional Centrelink aged pension and this is included in the total aggregated return, it is possible – likely in a low interest rate environment – that the annuity strategy could offer superior aggregated returns at all points of the investment time horizon

## Closing observations

The modern annuity, particularly lifetime annuities, have a number of characteristics that provide a greater degree of flexibility plus limited access to capital than the older, traditional annuity.

Annuities provide a range of benefits centred around being able to choose from a range of investment terms, varying levels of RCV, a guaranteed return, and once in place, are immune to the behaviour of investment markets.

The ability to underpin with certainty a chosen base income stream for terms up to the individual's lifetime, plus enjoy access to concessional Centrelink treatment, can make annuities a valuable retirement income planning tool.

The new CAS rules have to some extent addressed the contentious issue of the lack of capital access and death benefits to the estate, but it is important for advisers to understand the full ramifications of the new rules and how that fits into the client's investment strategy.

The bottom line is that annuities probably remain primarily a long term retirement planning option. Due to their structure (in comparison to other income stream options), it is likely that only a portion of any portfolio should be directed to lifetime annuities. The new rules and product innovation being introduced is providing greater, but still limited, flexibility and scope for planning strategies.

# Next super step: Repatriation of foreign pension funds



## Next super step: Repatriation of foreign pension funds

### Pulling together all the wealth options from around the world

Planning considerations should bring together all available accumulated financial resources. Given that many Australians have immigrated from overseas, it would be prudent for advisers to check whether there are any foreign pension entitlements available to call upon.

There is also an increasing number of “ex-pats” and Australians employed overseas that may well have foreign pension entitlements when they return home to either continue their career or retire.

All these people, whether they form a significant target market or not, may be in need of special advice to navigate the complexity of foreign fund transfer rules and repatriate pension entitlements back to Australia.

While UK transfers, QROPS, are probably the most recognised foreign pension fund transfer, they are simply one of a number of foreign pension funds that can be transferred directly to an Australian super fund. All foreign super funds, including QROPS, must comply with the same rules in order to access the tax concessions discussed below.

### At a “global” level

Essentially there are two “global” barriers that must be considered to allow the direct transfer of pension benefits from a foreign pension source to an Australian superannuation fund, and receive the available tax concessions:

- The foreign pension rules and the country’s tax rules, and;
- Whether it is considered a foreign superannuation fund under Australian law.

### Foreign fund rules

The foreign pension fund itself may have a number of stipulated conditions that must be met to allow cashing. Furthermore, if it can be cashed, can it be transferred to an Australian superannuation fund? If not immediately possible now, maybe it will be at a future date or after attaining a target age. If none of these apply, there may be a pension income stream payable at a future date/age.

Advisers should also explore any cost/benefit issues, including the cost of repatriation, that may be involved. For example, the benefit may have an automatic minimum earning – such as CPI or wages growth or be linked to years of membership – that will make it more beneficial to leave it in the foreign fund rather than withdrawing and being at the whim of investment markets.

The foreign fund rules may allow the cashing and transfer, but the country’s tax laws may impose tax on the amount transferred. Some analysis will be required to ensure that the “cost” of the tax does not outweigh the “benefit” of transferring to Australia. That was the beauty of QROPS when they were more easily accessible, as there was no immediate tax imposed by the UK on the QROPS transfer.

It would be prudent to work with a tax specialist of the relevant country to ensure that these issues are correctly assessed.

### Australian tax implications

Australian tax implications also need to be considered at this “global” level. While there may be penalties or costs (including tax) incurred now on the transfer from the foreign jurisdiction, if left with the foreign fund to ultimately pay a pension income stream, that income stream may eventually be taxable in the future on an ongoing basis in Australia, as Australian tax residents are taxed on their worldwide income.

Foreign pensions are also considered income for Centrelink purposes, so depending on the priority to qualify for Australian Centrelink benefits, the receipt of a foreign pension at a later date could reduce Australian Centrelink entitlements as compared to if funds were repatriated to the Australian superannuation system now.

Earnings credited to a foreign pension account from the date an individual ceases being a foreign tax resident (and

becomes an Australian tax resident), can be a double-edged sword:

- The earnings as they accrue overseas are not taxable in Australia, but;
- When eventually transferred to Australia, the growth from the date of becoming an Australian tax resident to the date the lump sum is received, known as Applicable Fund Earnings (AFE), is calculated, and will be subject to Australian tax in the year of receipt (detailed later in this paper).

Assuming a positive earning rate is achieved, the longer the benefit remains offshore, the bigger this AFE “ticking time bomb” can be, so there is an argument that it may be better to defuse the situation earlier by transferring sooner rather than later.

## The Australian side – understanding the technicalities

Having made the decision a foreign pension fund should be transferred, it is important to understand the technicalities.

1. An Australian taxpayer may receive a superannuation lump sum from a foreign super fund
2. Not all foreign pension funds are “foreign superannuation funds” under Australian law
3. Subject to meeting the conditions, including direct transfer from the foreign pension fund to an Australian fund, individuals can elect to receive concessional tax treatment on the AFE component of a “foreign superannuation fund” (as defined under Australian law). Otherwise, the tax liability will fall on the individual personally
4. A “transfer” from a foreign pension fund is a contribution, hence normal contribution rules are observed
5. It is not a rollover. No other funds in the world are “complying” as far as Australian law is concerned
6. The date when the client became an Australian tax resident is important to certain tax calculations

## What is a foreign superannuation fund?

The first hurdle is to decide whether the foreign pension fund qualifies as a foreign superannuation fund for Australian tax purposes. This is because only payments from foreign superannuation funds are eligible for concessional tax treatment if transferred directly to an Australian fund (see later notes).

The same assessment rules apply to all foreign pension funds. UK QROPS funds are the most familiar foreign funds that fit the definition, but that is because they meet the specific criteria of a “foreign superannuation fund” and not because of the UK domicile.

The technical definition of a “foreign superannuation fund” in the legislation is:

**“... a superannuation fund is a foreign superannuation fund at a time if the fund is not an Australian superannuation fund at that time...”**

Not very helpful!

The Australian Tax Office (ATO) has issued a number of private rulings on this question which provides some guidance:

### Private ruling 1051373410433:

- There is no essential single attribute of a superannuation fund
- Held that a fund had to exclusively be a ‘provident, benefit or superannuation fund’
- Though a fund may contain provisions for retirement purposes, it could not be accepted as a superannuation fund if it contained provisions that benefits could be paid in circumstances other than those relating to retirement

Based on this, as there is no formal definition, the foreign pension fund should meet some essential characteristics:

- Meet the key elements of the “sole purpose test”
- Be primarily for retirement purposes

## Next super step: Repatriation of foreign pension funds

- Not allow release of monies for other purposes

The takeaways from this for advisers is that great care is needed before providing advice that a foreign pension fund is in fact a foreign superannuation fund for Australian tax purposes. If in doubt, and if there is no clear evidence that a particular foreign fund is meeting the definition, it would be wise to seek a private ruling from the ATO before transfer.

If the foreign pension fund does not meet the Australian definition, it does not mean that the transfer is not possible, but simply Australian tax concessions will not be available on the transfer directly to the Australian fund, and additional tax consequences may arise. Given the potential complexities in this area, it would be prudent to seek specialist tax advice in relation to this.

Finally, advisers may come across cases where the client has worked in several foreign jurisdictions and transferred pension benefits between different countries other than Australia. In these cases, there are no tax implications until the benefit is paid to Australia, thereby deferring any tax considerations until repatriation.

## When did the client become an Australian tax resident?

Pinpointing when a client becomes an Australian tax resident is important when determining the split between AFE and balance of transfer (see below). This can be tricky as there is no set definition of when this occurs. Rather, each case is judged on the individual facts. The ATO does provide some guidance here:

<https://www.ato.gov.au/Individuals/international-tax-for-individuals/work-out-your-tax-residency/#Residencytests>

There is also a residency “decision tool” which clients can be directed to in order to help them select a specific date:

<https://www.ato.gov.au/Calculators-and-tools/Host/?anchor=AreYouAResident&anchor=AreYouAResident&anchor=AreYouAResident/questions#AreYouAResident/questions>

Given the complexity in dealing with the residency issue, clients should get specialist tax advice to confirm residency and in particular, the date from which residency

commenced. The bottom line for advisers is that you should be requesting that the client provide the actual date themselves, rather than selecting/advising on their residency status and the date yourself.

## Australian tax treatment

Foreign pension fund transfers into Australia are taxed differently depending upon:

- When it is received in Australia – before or after six months of Australian residency
- Whether the member makes an election regarding “applicable fund earnings”
- The non-concessional contributions caps, and;
- The age of the member in the financial year the transfer occurs, as this will affect contributions caps and work test requirements

### Note:

Special rules apply for members transferring superannuation between Australia and New Zealand under the Trans-Tasman retirement savings portability scheme.

## Applicable fund earnings (AFE) and the balance of transfer

A transfer from a foreign pension fund is split into two components for tax purposes:

- Applicable fund earnings
- Balance of transfer

### 1 Applicable fund earnings (AFE)

Applicable fund earnings (AFE) is generally the earnings that accrue on the foreign pension fund from the date the individual becomes an Australian tax resident until the date the lump sum is paid.

In most cases, where the individual was a member of the foreign fund as a foreign resident, moved and became an Australian tax resident at a later date, requested the transfer of the foreign fund balance at a future time after

## Next super step: Repatriation of foreign pension funds

becoming a resident, and where there is a single transfer of 100% of the foreign pension amount, the calculation of the AFE is:

**AFE = lump sum received – foreign fund balance just before becoming an Australian tax resident**

This calculation can get more complex where the foreign pension amount is transferred in multiple (separate) tranches, or contributions to the foreign fund have been made or additional benefits are credited to the foreign fund during the Australian residency period.

### 2 Balance of transfer

Balance of transfer is the balance of the foreign fund up to the date when the individual became an Australian tax resident.

## Currency exchange rates

Currency exchange rates are different at each of these dates. That is, the date of becoming an Australian tax resident and the date the lump sum is received. The ATO has stated in ID 2015/7 that when calculating AFE, use the exchange rate on the date the foreign superannuation lump sum is received.

## Timing of receipt of the foreign lump sum

There are different tax implications for the above components depending upon the timing of the receipt of the foreign superannuation lump sum – within 6 months of Australian residency or later than 6 months.

### 1 Receipt within 6 months

If received within 6 months of becoming an Australian tax resident, the entire amount – AFE and balance of transfer – is tax free. This is true whether it is withdrawn or transferred to a complying Australian superannuation fund.

The entire amount counts toward the non-concessional cap if transferred to the receiving Australian fund.

### 2 Receipt after 6 months

#### Election

If the foreign lump sum is received after six months of tax residency, the AFE is subject to tax. If the payment is made directly to the Australian superannuation fund, members have the option to elect to have the AFE taxed in the fund at the concessional rate of 15% rather than at their

individual marginal tax rate. In this case, the AFE amount is not assessable under either the concessional or non-concessional contribution caps.

This election is only possible where, immediately after the lump sum transfer, the individual has no balance remaining in the foreign pension fund. The election notice must accompany the contribution.

The balance of transfer is tax free but does count against the non-concessional cap.

No election is possible if the foreign payment was not made to an Australian superannuation fund. In this case, the AFE amount is added to the individual's assessable income and taxed at their marginal tax rate.

#### No election

Or alternatively, if the payment is made directly to the Australian superannuation fund, and the individual chooses not to make an election, then the AFE amount will be treated as assessable income of the individual and taxed at their marginal tax rate. It is also counted against an individual's non-concessional contributions cap.

The balance of transfer is tax free and counts against the non-concessional contribution cap.

## Normal contribution and cap apply

Fund capped limits were abolished from 1 July 2017 onwards. Prior to this date, if the amount received by the Australian superannuation fund was in excess of the fund capped limit (\$540k/\$180k), the excess amount had to be returned to the foreign pension fund.

From that date on, there is no limit to the amount of non-concessional contribution that a fund can accept, but the normal non-concessional contribution caps apply. Any excess non-concessional contribution received is dealt with under the normal excess non-concessional contribution rules. The work test, or work test exemption rules, also apply where the member is aged 65 or older. Finally, transfers generally will not be possible from age 75 onwards.

## Summary of tax implications

The table on the following page summarises the above tax implications when received by the Australian superannuation fund.

## Next super step: Repatriation of foreign pension funds

	Applicable fund earnings (Growth element)			Balance of transfer (Total transfer – growth element)	
	When foreign transfer received by Australian super fund	Tax applicable	Counted against super cap	Tax on balance of transfer	Counted against super cap
No election required	Within 6 months of becoming Australian tax resident	Not assessable at all	Non-concessional cap	Not assessable at all	Non-concessional cap
No election made	After 6 months of becoming Australian tax resident	Assessable to individual at MTR + Medicare levy	Non-concessional cap	Not assessable at all	Non-concessional cap
Election made	After 6 months of becoming an Australian tax resident	Assessable to Australian super fund at 15%	Does not count toward any cap	Not assessable at all	Non-concessional cap

## Checklist for the direct transfer of foreign pension lump sums to a complying Australian fund

### Process to elect the AFE amount to be taxed at 15% in receiving fund

- Check if the foreign fund is able to pay lump sum benefit:
  - Identify any conditions of release that may apply under the foreign jurisdiction and consider the tax implication. This may require specialist tax advice
- Confirm the foreign fund meets definition of an Australian foreign super fund:
  - If no evidence of previous transfers from this jurisdiction, consider whether a private ruling is required
- Consider the Australian tax implications upon receipt by the Australian superannuation fund, including any excess non-concessional contribution issues and tax election
- Request direct payment from foreign super fund to Australian complying fund
- Calculate the AFE. Client should provide the start date of Australian tax residency, and where the election is appropriate, provide election form to the receiving fund

## 1 July 2017 onwards - fund capped limit abolished

- Fund can accept any amount
- Greater than (\$300k/\$100k), then normal excess non-concessional contribution rules apply
- No need to return to foreign fund

## Conclusion

In a land of immigrants and with an expanding globally mobile workforce, advisers need to check if there is access to foreign pension fund assets if they are to draw together and repatriate all the available client assets when planning for retirement.

In doing so, advisers need to be aware that both foreign and domestic superannuation/pension and tax laws may operate to complicate the issue. As part of the repatriation process, it could well be prudent to have the client work in conjunction with a tax consultant that specialises in the pension fund's resident country.

Over and above this, our own super and tax laws are quite complex and there are issues such as whether the foreign pension fund meets Australian definitions and pinpointing the start date of Australian residency, that may also require collaboration with other tax specialists.

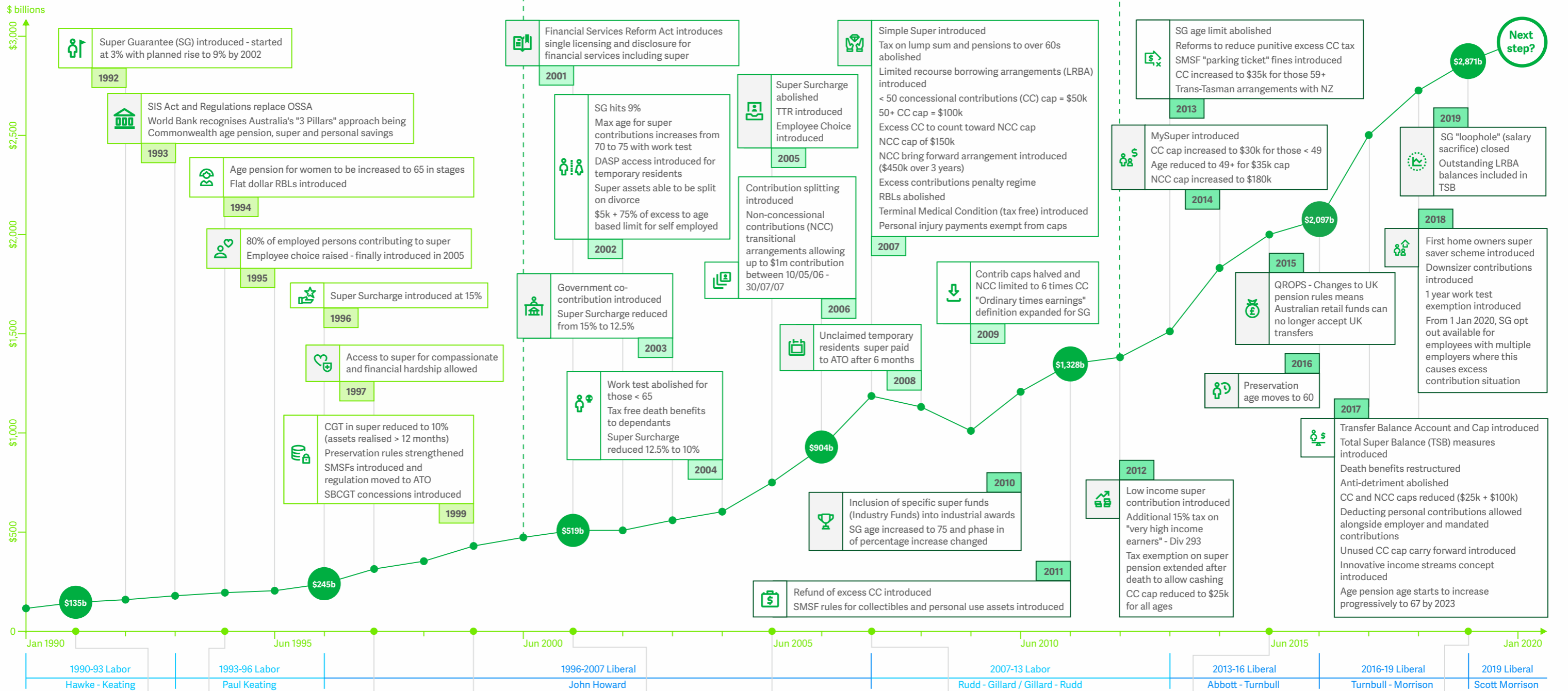
The ability to access and transfer a foreign pension lump sum or apply for and achieve a foreign pension income stream can lead to very valuable additional financial resources for your client. These additional resources should not be discounted as part of their retirement plan.

# 30 years of Australian superannuation

1990 Super coverage all employees 64%

2000 87%

2012 90%



# Next super step: Managing CGT in and out of super



## Next super step: Managing CGT in and out of super

### Optimising the after tax return

Dealing with capital gains and losses is an integral part of managing a client's financial affairs. Given the heavy bias to superannuation as the major wealth creation vehicle, dealing with capital gains and losses outside the superannuation environment is in danger of becoming a "lost art" for many advisers.

Put simply, whether in or out of superannuation, a capital gain or capital loss is the difference between what it cost to acquire the asset and what is received when it is disposed of.

It gets more complicated where there are multiple assets, such as multiple parcels of shares from dividend re-investment schemes that have multiple cost bases. To calculate capital gains and losses, the asset's cost base must be linked to the sale proceeds of the same asset. This raises one of the most critical issues – the keeping of complete financial records. Identifying the sale price of the asset is normally fairly easy but finding the record of the purchase price that may have been many years prior can be challenging.

There are many other factors that can increase complexity including whether the purchase date was pre or post the CGT legislation, whether the indexation or discount method applies, and adjustments to the cost base from corporate actions, to name just a few.

### Some basic concepts

1. There is no such thing as a separate capital gain tax (CGT)
  - a. When a capital gain is made, it is added to assessable income and taxed at the marginal rate of the individual or entity
2. Only non-superannuation assets acquired on or after 20 September 1985 are subject to assessment for capital gains or losses. Assets purchased prior to this date are known as "pre-CGT" assets and any gain (or loss) is not assessed for taxation purposes
3. Superannuation funds do not have "pre-CGT" assets
  - a. Superannuation assets were brought into the CGT regime as at 1 July 1988
  - b. Assets owned at that date have the choice to be valued at cost or market value
4. It is only realised capital gains or losses (when the asset is disposed of or deemed disposed of for tax purposes) that create a CGT event
5. Capital losses can only be claimed against capital gains – they cannot be used to reduce income
6. Most personal assets are exempt from CGT including:
  - a. Residential home
  - b. Motor vehicle (includes motorcycle)
  - c. Personal use assets<sup>1</sup>
7. The point at which an entity makes a capital gain or loss is usually when it enters into the contract for disposal, not when it settles
8. For Australian tax residents, CGT applies to assets held anywhere in the world
9. Death itself does not create a CGT event, it is deferred until the eventual sale or realisation of the asset by the executor or ultimate beneficiary

<sup>1</sup>Personal use assets are CGT assets, other than collectables, used or kept mainly for the personal use or enjoyment of you or your associates. Any personal use asset you acquired for less than \$10,000 is disregarded for CGT purposes. Personal use assets include boats, furniture, electrical goods and household items. It also includes an option or right to acquire a personal use asset. The main residence, car or a motorcycle are not classified as personal use assets but are exempt.

### Reducing the capital gain

Making a capital gain is a "nice problem" to have but having to pay tax on it is not. There are a number of elements that contribute to the reduction of the assessable gain and therefore the tax payable:

1. The Indexation of the cost base; or
2. The discounting of the capital gain (this replaces point one above)
3. Applying capital losses
4. Where they are specifically exempted

Eligibility to apply any of these depends on the type of entity that acquired the asset – individual, company, trust or super – and the date of acquisition. In some situations, there is a choice of which method (1 or 2 above) is

## Next super step: Managing CGT in and out of super

available, in which case, the one that results in the least tax payable can be chosen.

### Indexation of cost base method

The indexation of the cost base method has been replaced by the discounting method, but it is still an available option to calculate the capital gain if:

- A CGT event happened to an asset acquired before 11:45am on 21 September 1999, and;
- The asset was owned by the entity for 12 months or more.

If the entity is an individual, complying super fund or trust, and the two conditions above are met and the entity wants to use the indexation method, they must choose to do so, otherwise the discount method will apply. The way the tax return is prepared is sufficient evidence of the choice.

If the entity is a company (other than a listed investment company) and the capital asset meets the above conditions, it must use the indexation method to calculate the capital gain.

The 12-month ownership condition is modified in some situations. For example, the indexation method can be chosen if a CGT asset is acquired:

- As a legal personal representative (LPR) or beneficiary of a deceased estate. The 12-month requirement is satisfied if the deceased acquired the asset 12 months or more before it is disposed of, or;
- As the result of a marriage or relationship breakdown. The 12-month requirement is met if the combined period that the two separating spouses have owned the asset is more than 12 months.

The indexation factor effectively allows the cost base of the asset to be increased by the consumer price index (CPI). Increasing the cost base reduces the assessable gain and therefore reduces the tax liability.

As mentioned above, this method was discontinued on 21 September 1999 for assets acquired on or after that date. Therefore, for those assets acquired before then, and if the CGT event happened on or after 11:45am on 21 September 1999, only index the elements of the asset cost base up to

30 September 1999. Use this formula to calculate the indexation factor:

$$A \div B = C$$

Where:

A is the CPI for quarter ending 30 September 1999

B is the CPI for quarter in which expenditure was incurred

C is the resulting indexation factor

### Discounting of capital gain method

The discounting of capital gain method allows the capital gain to be reduced by the discount percentage. The capital gain can be reduced only after all the capital losses for the income year and any unapplied net capital losses from earlier years have been applied. It is the more generally used method to reduce the capital gain as we move further away from the indexation method date restriction.

The discount method can be used to calculate a capital gain on most assets where owned for 12 months or more.

The discount method can be used if:

- The entity is an individual, trust or complying super fund
- The CGT event happened to the asset after 11:45am on 21 September 1999
- The asset was acquired at least 12 months before the CGT event
- The indexation method was not elected to be used

The discount method does not apply to companies.

Different discount percentages (rates) can apply. The discount percentage is the percentage by which the capital gain is reduced.

The discount percentage is 50% for individuals including flow through from trusts, and 33.33% for complying super funds and eligible life insurance companies.

## Next super step: Managing CGT in and out of super

For foreign resident individuals, the 50% discount was removed or reduced on capital gains made after 8 May 2012 on taxable Australia property<sup>2</sup>.

<sup>2</sup>Taxable Australian property includes a direct interest in real property situated in Australia; a mining, quarrying or prospecting right to minerals, petroleum or quarry materials situated in Australia; a CGT asset that you have used at any time in carrying on a business through a permanent establishment in Australia; an indirect interest in Australian real property – you and your associates hold 10% or more of an entity, including a foreign entity, and the value of your interest is principally attributable to Australian real property. Taxable Australian property also includes an option or right over one of the above.

## Capital losses

Where an asset is sold for less than what it cost, it is generally a capital loss. The difference between the two amounts is your capital loss.

A capital loss can be used to reduce any capital gain made in the same financial year. If no capital gain has been made in the same financial year, the loss can be used to reduce a capital gain in a later year. That is, the capital loss can be carried forward indefinitely to be used against capital gains made in future years.

Capital losses can only be deducted from capital gains – it is not possible to deduct capital losses from other income.

## Exemptions from assessment

Certain capital gains are exempt from assessment and therefore any gains are tax free. Similarly, any capital losses made on the realisation of exempt assets do not generate a capital loss for tax purposes.

Some of the common exemptions are gains made from the realisation of:

- Main residence
- Motor vehicle and motorcycle
- Personal use assets
- Sale of a small business where it meets the small business CGT concession guidelines

## Choosing the index or discount method

For assets acquired before 21 September 1999, there will be a need to consider which method to use. This depends on the type of asset, the entity holding it (individual, trust,

company, superannuation fund), dates owned, past inflation rates and if capital losses are available.

While generally the 50% discount method will give the best net result, that is not always the case and it is often necessary to do the comparative calculations to be sure that the best result is achieved.

## Death and CGT

When a person dies, an asset in their estate can pass:

- Directly to beneficiaries (that is, people entitled to the assets of the deceased estate)
- Directly to the deceased's LPR – their executor or an administrator appointed to wind up the estate
- From an LPR to a beneficiary

A beneficiary or LPR is taken to have acquired the asset on the day the person died, but CGT does not apply when the asset is acquired by either of these parties. CGT may apply if the asset is disposed of at a later date.

If the asset is transferred to a tax-advantaged entity – for example, a church or charity or the trustee of a complying super fund – or to a foreign resident under the terms of the will, CGT will apply to the transfer and must be accounted for in the deceased person's date of death tax return.

The date of the person's death is relevant when calculating the capital gain.

If the deceased person acquired the asset before 20 September 1985, the cost base is the market value of the asset on the day the person died.

If the deceased acquired the asset on or after 20 September 1985, the cost base is taken to be the deceased's cost base, that is, the value paid by the deceased for the asset.

With death, any unused capital losses cannot be passed on to the beneficiary or LPR. That is, no one can use such losses to offset against any net capital gains, they are simply lost.

## So, there is a realised capital gain – what is the assessable gain?

Having realised a capital gain, the following steps are taken in the calculation of the assessable portion of the gain – that is, the amount that is to be added to assessable income to be taxed:

### Step 1: Reduce capital gains made by capital losses (if any) in same income year

- If there are capital losses (realised), they must be used to offset any capital gain (no choice)
- Can choose which asset (if multiple assets disposed) to reduce capital gains
  - Net loss if capital losses > capital gains
- Certain provisions require gains to be disregarded e.g. 15 year small business exemption

### Step 2: Apply capital losses from previous years to any remaining gains

- Can choose which asset to reduce capital gains

### Step 3: Reduce by discount percentage on gains from assets owned for at least 12 months

- Only certain entities get the discount - apply the relevant discount percentage;
  - 50% for individuals
  - 33.3% for super funds

### Step 4: Apply any small business exemptions

- Where the asset is a business active asset meeting the small business concessions requirements

### Step 5: Add up all capital gains remaining

- Sum is net capital gain to be included in assessable income for the income year

## Best use of capital losses

Capital losses have been mentioned in the preceding notes, but they do deserve a special note in their own right.

Four key characteristics to remember are:

1. Capital losses can only be applied against capital gains

2. If there are losses available, either from the current or past financial years, they must be used against realised capital gains – there is no choice
3. If unable to be used, they can be carried forward
4. Realised capital losses die with you. Try not to die with capital losses

### Note

Unlike capital losses, income losses can be used to effectively reduce "CGT". This is because assessable capital gains are added to assessable income and taxed at the marginal rate. Assessable income is reduced by income (revenue) losses and therefore reduces the amount of tax payable.

Here are some technical considerations to help make the best use of capital losses:

- Consider applying losses in this offset order depending on when the asset is purchased:
  - Check if the indexation method is available to apply to the asset
  - Any capital gains on assets owned for less than 12 months
  - Any capital gains on assets purchased before 11:45am, 21 Sep 1999
  - Any capital gains on assets purchased on and after 11:45am, 21 Sep 1999
    - Have to use the loss first and only get 50% discount on reduced amount
- Realising losses in the appropriate year (e.g. 30 June disposal instead of 1 July)
  - Transferring to related party, including spouse (no Centrelink impact)
    - Transferring this way is a "realisation" of the asset and creates a CGT event
- Don't die with realised capital losses
  - Sell assets with gains to absorb the losses before death
    - In-specie gift or contribute to super if possible
      - this creates a CGT event
  - Unrealised capital loss on death can be passed on to beneficiary
    - If the deceased has not realised the losses, it may be better to hand over the investment (in-

## Next super step: Managing CGT in and out of super

specie and unrealised) to the beneficiary who may then be able to sell and realise the loss to better effect

- Plan for the capital gains and losses to be distributed in tax effective manner post death
  - Flexible will is going to help
  - Consider realisation in the estate
    - Or if more advantageous, pass on the investments (whether gain or loss) to appropriate beneficiaries.

## Superannuation is special

Whether it be in accumulation or pension phase, managing capital gains and losses within the superannuation environment may still have advantages.

### Accumulation

While it may be preferable to realise capital gains in retirement phase (pension), realising a gain on an asset held longer than 12 months in accumulation mode results in a 33.3% discount applied to the gain, which gives an effective tax rate of 10%. This is usually a significant improvement on paying tax at an individual's marginal tax rate.

Even losses can be used to advantage on a platform. The Netwealth platform is a case in point, as the fund can get an immediate credit in dollar terms for the loss realised, unlike an SMSF or individuals where the losses can only be recovered provided there are other capital gains to be offset.

Probably the thing to remember for planning purposes is to plan ahead. There is little advantage in trying to contribute or acquire from the member an asset that already has a large gain attached, as the act of contribution or acquisition will create a capital gain event for the entity. The superannuation fund will acquire the asset with a cost base equivalent to the sale price, thereby providing shelter only to future gains i.e. the asset transfer should be done preferably when the asset value is at its lowest.

### In pension mode

The application of the exempt current pension income (ECPI) concession reduces the tax rate on assessable fund income, including realised capital gains, to zero. Therefore,

from a tax perspective, it is best to ensure that capital gains are realised in pension phase.

Where appropriate, strategically considering the commencement of a pension retirement income stream as early as practicable may be beneficial for a number of reasons:

- ECPI operates to reduce fund tax, including on realised capital gains, to zero
- Pension payments can be commuted to a lump sum thereby maintaining flexibility and accessibility
- Tax free status of pension accounts may change one day, so consider refreshing the cost base to reduce possible future impact of an adverse rule change
- Death benefit pensions, particularly reversionary pensions, provide maximum flexibility to manage tax and estate planning opportunities to best effect
- It is best to die in pension mode – tax free treatment is extended until assets are paid out

Conversely, there are some limitations in dealing with capital gains and losses in pension mode. For example:

- There is a downside to leaving an asset in a loss position in a pension as there is no credit on the realisation of the loss as there is no fund tax payable
- The ability to commence a pension is limited to the transfer balance cap, with any excess amount having to be rolled across to accumulation or exiting as a lump sum payment:
  - Advisers should remember that while pension payments are not transfer balance account (TBA) debits and do not reduce the member's TBA, commutations of pension payment above the minimum pension are TBA debits and do create "cap space"
  - This newly created cap space can be used to commence additional pensions which can then be used to manage capital gain positions

### SMSFs

SMSFs have their own peculiar issues that demand special attention, including:

- In regard to losses, an SMSF will need to realise capital gains in order to use capital losses:

## Next super step: Managing CGT in and out of super

- In comparison, a platform fund has gains from other fund members that can absorb the loss, thereby allowing the credit for the loss to pass straight through to the member account (even before the end of the financial year)
- The SMSF will have to wait until the completion of its annual return for any credit to be reflected in the member account. In contrast, this can happen immediately in a platform environment
- Under current legislation, the “disregarded small fund asset”<sup>3</sup> rules may operate to force an SMSF to use the proportionate method to calculate tax if the fund also has an accumulation balance. In these cases, unless the SMSF is 100% in pension mode, it will always have a tax liability on a part of the assessable income
- Remember also the impact and complication of any transitional CGT relief taken as at 1 July 2017 with the introduction of the transfer balance account and cap rules. This often resulted in a crystallization of a CGT liability which is deferred until future realisation

<sup>3</sup>In some SMSFs, the “disregarded small fund asset” rules may operate to force an SMSF to use the proportionate method to calculate tax if the fund also has an accumulation balance. In these cases, the SMSF may have a tax liability on a part of the assessable income.

## Rolling over a pension – is it a CGT event?

Can a superannuation pension be rolled over from one provider to another – say an SMSF to a platform or platform to platform – in pension mode?

The short answer is no.

A pension is a contractual arrangement between the member and the trustee of the fund. If the member changes superannuation providers, the original pension ceases and a new one commences with the new provider.

If the original pension ceases, it must revert to accumulation. The actual process is that the original pension is commuted back to accumulation. It therefore becomes taxable at fund level. Where there is a 100% commutation of the original pension, the whole account drops back to accumulation. On the other hand, if there is a partial commutation, the original pension continues.

Switching from one provider to another is a realisation of assets (even if completed in-specie) and therefore creates

a CGT event and is subject to CGT tax. If the process is completed as a single transaction (100% commutation), it is completed in accumulation mode and is taxable.

If it is completed in at least two stages – say 90% partial commutation with the balance treated as partial commutation at a later date – the pension continues. This allows the ECPI to operate as the account is still in pension mode at the time of the first partial commutation. The tax rate is therefore zero. The second full and final commutation should be managed to consist of cash or non-CGT assets to complete the closure and transfer.

### Backing for the strategy - Private ruling: 1051245789625

If member partially commutes a pension by way of in-specie asset transfer, will any gain realised be disregarded?

ATO answer was ‘YES’, partial commutation means original pension still exists.

Capital gains taken to be realised in tax exempt pension phase and therefore not taxable.

## Conclusion

While dealing with capital gains and losses within super is usually preferable, there are many valuable strategies available for effectively dealing with gains and losses outside the superannuation environment.

As always, the key to achieving the best outcome for your client is to understand the rules, do the calculations and action the decisions in the correct manner. There are many issues such as timing of purchase and realisation, whether in or out of superannuation or pre or post death, and strategic use of losses that can impact on the final result.

Finally, we suspect also that many people underestimate the potential value of losses. While it is probably preferable to avoid capital losses, they are a fact of an investor’s life and armed with knowledge and time, an adviser can take a potentially “bad situation” and turn it into a positive.

# Next super step: Death and passing on benefits tax effectively



## Next super step: Death and passing on benefits tax effectively

### Passing on tax effectively

Death appears to be one of the more “troublesome” aspects of dealing with superannuation.

Payment of death benefits is governed under both the Superannuation Industry (Supervision) Act 1994 and Regulations (SISA and SISR) and the Income Tax Assessment Act 1997 (ITAA). Broadly, the SIS laws tell us to whom and how the death benefits can be paid, and the tax law tells us how much “death tax” will need to be paid.

### Cashed as soon as practicable

It is compulsory to payout (cash) a deceased member’s benefit as soon as practicable. The phrase “as soon as practicable” is not defined and needs to be judged on the facts of each case. For example, it may take some time for trustees to find and confirm a deceased member’s dependants or LPR, or cashing may be delayed due to legal challenges or proceedings.

### What is cashed and who can it be cashed to

Broadly, a member’s death benefit can only be “cashed” in favour of either, or both, the member’s LPR (estate) or one or more of the member’s SISA dependants at the date of death. For the purposes of the payment of death benefits, a dependant is defined as:

**Dependant: in relation to a person, includes the spouse of the person, any child of the person and any person with whom the person has an interdependency relationship.**

The definition of dependant (via interdependency) includes someone who, at the time of the member’s death, was financially dependent upon the member. However, the ATO and SIS have each come up with their own interpretation of the term “financially dependent”. The ATO, in several private rulings, has adopted a narrower interpretation to financial dependency; providing that the potential beneficiary would need to be unable to meet the basic daily necessities of life without the financial assistance in order to qualify.

SIS on the other hand, has determined that a potential beneficiary may qualify as a financial dependant if there was simply financial support of the individual at the time of the member’s death. There is no requirement for the beneficiary to be fully supported or even have a need for that support to be provided.

Death benefits must be cashed as soon as practicable after the member dies. “Cashing” is defined as being paid in one or more of the following forms:

- A single lump sum
- An interim lump sum and a final lump sum
- One or more retirement phase death pensions and annuities

The ability to pay the death benefit as a pension or annuity is limited to those beneficiaries who at the time of the member’s death were a dependant of the deceased and, in the case of a “child pension”, was either less than 18 years of age or aged between 18 and 25 and financially dependent on the member.

With “child pensions”, the benefit must be cashed as a death benefit lump sum upon the child reaching 25 years of age, unless the child has a disability. The regulations effectively mean that a death benefit income stream cannot be paid to an adult child unless they are aged between 18 and 25 and financially dependent or have a disability.

### When does the pension cease for tax purposes?

Generally, unless it is a reversionary pension, when the member dies, the trustee no longer has any liability to pay the pension and therefore the pension ceases.

If a pension ceases, it drops into accumulation mode and this means that it becomes taxable at the fund level. This led to a quasi-death tax for the deceased member’s beneficiaries where a lump sum death benefit was payable because the assets would be realised in accumulation mode in order to payout the death benefit lump sum. Realisation of the assets in this manner constitutes a CGT event with the potential to attract CGT payable by the fund.

To address this unintended consequence, from 1 July 2012, the Government brought in regulations to specify that where a member who was receiving a non-reversionary super income stream that was in the retirement phase dies, the fund will continue to be entitled to claim ECPI (pension tax free status) in the period from the member's death until their benefits are applied to commence a new super income stream or paid as a lump sum (subject to the benefits being cashed as soon as practicable).

## 1 July 2017 – the new era of death benefits

From 1 July 2017, the payment of death benefits changed. The key changes included:

- Once a death benefit, always a death benefit. As a result, the payment will always be taxable as a death benefit. It can never become a member benefit. The advantage of this change is that as a death benefit, it is tax free on payment to a dependant at any time
- A death benefit can never be rolled over to, or held in, accumulation. To keep a death benefit in superannuation, the only choice is a death benefit income stream(s), in either the existing fund, or rolled over to an income stream in a new fund, to an eligible dependant as described above
- Death benefits must be kept separate from the beneficiaries' own super balances:
  - Can combine multiple death benefits into a single death benefit
  - Can have own accumulation and retirement income stream, in addition to a separate death benefit income stream
  - All retirement phase income streams (death or otherwise) are counted to the individual's transfer balance cap (TBC)
- Intergenerational transfer of superannuation wealth is limited by the TBC:
  - Death benefits income streams always count against the dependant beneficiaries TBC of \$1.6m. As death benefits can only be retained in superannuation by way of death benefit income streams, this will effectively limit the amount that can be transferred to a dependant in superannuation

- A new death benefit income stream, usually as a result of a binding nomination or so directed at the trustee's discretion, counts against TBC and is valued upon commencement of the pension (as soon as practicable)
- Reversionary death benefit income streams will continue and commence to pay beneficiaries from the date of death, but will only count 12 months post death and is valued as at the date of death
- Dependant child or children receive an additional "child modified cap" that is separate to, and does not impact upon, their TBC either at the time or later in life when they may finally retire.

### Note

Child modified cap is based on %age super distribution received x \$1.6m

- Dependants and tax:
  - Death lump sums (paid upon death or any subsequent commutation of death benefit income stream) paid to tax dependants are always 100% tax free
  - Death benefit income streams are 100% tax free if either deceased or beneficiary is aged 60 or more
  - Where both deceased and beneficiary are under 60 years of age, the taxable component of the beneficiary income stream is taxed at their marginal tax rate less a 15% tax offset
  - Commuted death incomes streams, partial or full, are death benefit lump sums and always tax free

## Planning opportunities with death

Planning opportunities on a member's death may revolve around the ability to minimise, or at least postpone the payments of tax as long as possible. Here are some strategies that advisers could consider:

- Commute and pull out prior to death – the day before death is ideal but any time (shortly) before death works. This may provide advantages for both dependants and non-tax dependants alike as the tax is levied at the member rate – tax free if the deceased member is 60 or older
- Aim to die in pension mode. This may allow beneficiaries (particularly non-dependants) time to

## Next super step: Death and passing on benefits tax effectively

better manage tax liabilities within the fund prior to payment of a benefit

- Re-contribution strategy to maximise tax free component:
  - Tax free components are always tax free to both dependants and non-dependants
  - Going to income stream locks in the tax free proportion going forward – this may be a strategy for estate planning (this is also true for a transition to retirement income stream even though it is not an income stream in retirement phase)
- Aim for tax free components to be available to be directed to non-dependants

As a general rule, it can be best to remain within the superannuation system as long as possible. This provides opportunities to reduce both fund level and individual tax on benefit payments on an on-going basis. This normally means ensuring that the beneficiary can access a death benefit income stream to allow it to remain in the super system.

Access to a death benefit income stream is possible via three routes (all requiring the beneficiary to be a dependant at the date of the deceased's death):

- **Reversionary nomination:** this presents probably the best planning opportunities as it gives access to 2 x TBC (\$3.2M) in tax free pension mode for up to 12 months post the death of the original member. This can provide:
  - Additional tax free income for 12 months
  - The time and tax structure to manage/resolve any capital gains issues within the tax free pension structure
  - Provide time to undertake more effective tax planning strategies to maximize assets within the superannuation tax shelter structure
- **Binding death benefit nominations:** nominations can either be:
  - Specific by nominating the beneficiary, the amount and the taking of the benefit as income stream, or;
  - At the beneficiary's choice by simply nominating the beneficiary and the amount leaving via the choice of lump sum or income stream to the

beneficiary. Advisers should check that the specific fund rules do allow this option.

- **Trustee discretion:** where there is no reversion and no binding nomination, the form of the death payment is at the discretion of the trustee within the rules of the fund and legislation. It should be noted that under these circumstances, the rules of many retail/platform funds force trustees to pay the death benefit to the LPR (which will take away the opportunity to have a death benefit income stream).

### Note

If a death benefit is paid to a deceased member's LPR, it must be paid as a lump sum. There is no opportunity to pay it as a death benefit income stream via the LPR or to the estate. Where the LPR pays the death benefit to a tax dependant, it will be tax free. Where it is paid to a non-tax dependant, it is the LPR's responsibility to ensure that it is taxed correctly and remitted to the tax office.

The use of a testamentary trust alongside death benefit income streams should also be considered. There are many benefits to using a testamentary trust but from the tax perspective, the main advantage is the fact that child beneficiaries are taxed at adult rates – that is, have the benefit of the tax free threshold to absorb any distribution of earnings from the trust.

Assets can be in-specie transferred into a testamentary trust from a superannuation death benefit, though the benefit will have exited the superannuation environment to do so. For those who are tax dependants, no tax is payable on the payment of the benefit from superannuation to testamentary trust. For non-dependants, tax will be payable on any taxable component unless the death benefit is composed of 100% tax free components. This provides a planning opportunity to create and direct 100% tax free benefits (e.g. complete a re-contribution strategy) to allow these tax free benefits to flow to the testamentary trust and utilise its own tax benefits.

## Planning opportunities with the TBC

The March 2020 Netwealth superannuation roadshow, “Next super steps”, went through a number of planning opportunities associated with utilising the TBC thresholds to maximum advantage.

The more innovative of these strategies revolve around the fact that a reversionary death benefit income stream:

- Continues as a death benefit income stream from the date of death but is not a transfer balance credit to the beneficiary’s account until 12 months after the date of death
- The eventual value of the transfer balance credit that is recorded against the beneficiary’s TBA is the deceased member’s account value as at the date of death 12 months earlier
  - This can be a positive in rising markets as the value 12 months previously is likely to be lower than the actual account balance 12 months after death. This results in any gain in the 12-month period not being tested against the TBC
  - The opposite can be true in a falling market as the value 12 months later may be less. In such cases, valuable TBC “cap space” is used to no value

This strategy is normally discussed in relation to where both partners are retired and each running their own income stream. What is sometimes overlooked is the opportunity for the beneficiary to proactively begin their own retirement income stream during this period. This can allow them the opportunity to manage any capital gains/losses issues more effectively over the 12-month period leading to the TBA credit being recorded.

Using this reasoning, another strategy could allow two income streams from the same deceased member’s account. If the deceased had a balance that was composed of both a reversionary income stream already at the \$1.6m cap, and an accumulation account of another \$1.6m for the balance, it would be possible to:

- Continue the reversionary pension as there is no TBA credit for 12 months
- Elect to begin a death benefit income stream with the balance up to the \$1.6m cap utilising their own \$1.6 TBC. This delays the exit of the \$1.6m accumulation from the superannuation environment
- Use the 12-month period to manage any tax issues and receive and utilise the tax advantaged pension situation
- At the end of the 12-month period, commute one of the pensions to bring the beneficiary within the TBC
  - Such a commutation will exit the superannuation environment, but will be a tax free death benefit

There are several variations and refinements of the strategies in the presentation, but they all have the effect of allowing more money to remain in superannuation after death and provide significant and strategic planning opportunities.

## Conclusion

Death is a tricky area for all concerned. For the member, when trying to think ahead and establish plans that are tax efficient and robust enough to sustain possible changes to circumstances and even possible estate challenges. For advisers, to understand and use the complexities of the legislation in this area to achieve the member’s wishes and optimise their benefits. For the beneficiary, to work through and action these plans during a period of grief and mourning.

Blended family situations, particularly those utilising SMSF, have been shown to be more at risk of finding plans invalidated due to technicalities or actions and challenges from either side of the blended family members.

One last strategy all advisers should consider with their SMSF clients is whether the SMSF is approaching its “use by date”. Perhaps ask whether the members may be better served by winding it up to rollover to a platform to implement many of these strategies and importantly to avoid the complexities of death benefits and windups, and perhaps help minimise any potential challenges against the fund and trustees.

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