Reshaping the future

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April 2021

Divorce: I do, I do, we don't	Insurance: A super savvy TPD payout	Bonds: An ally, a stronger bond	Superannuation: Tools of the trade

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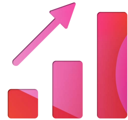

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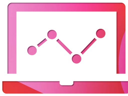

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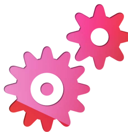

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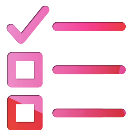

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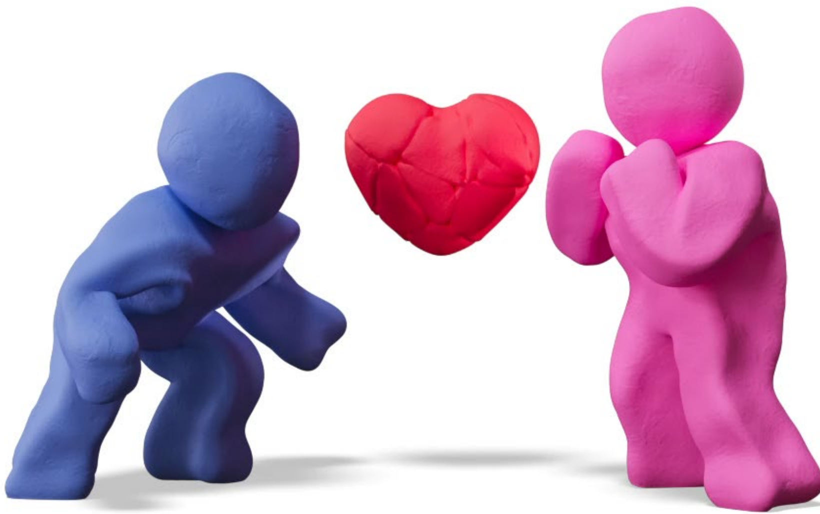
I do, I do, we don't



Super and divorce: I do, I do, we don’t

Divorce can be both emotionally and financially distressing. It is exactly the time your clients need a cool voice of reason and experience to guide them through such a stressful period. Unfortunately, it seems that clients often do not consult with their financial planner until after the event and the balance of the couple’s property – super, assets, cash, physical property etc – has been split and restructured to allow them to move forward.

Early intervention with detailed knowledge of the law could influence valuation strategies, asset choice, tax impacts and other factors which together could make a significant improvement to the outcome.

Advising in this area requires a good understanding of the interactions between Family Law, Superannuation Law and Tax Law as well as a great deal of patience and emotional sensitivity. One point to note is that planning opportunities generally only exist when couples are willing to negotiate and agree between themselves rather than ending up in Court where the Court simply makes what the Court thinks are appropriate orders.

Understanding the process

The Family Law Act 1975 and Family Law (Super) Regulations 2001 are key pieces of legislation when dealing with the splitting of a couple’s superannuation interests.

There are three ways that a split can be implemented:

1. A Consent order from Federal Magistrates Court or Family Court.
2. Binding Financial Arrangement (BFA) between the parties
    a. A “super agreement” is a special BFA that deals with a super interest.
3. Contested Family Court hearing where the Court makes the decisions directing the outcomes.

Generally, a consent order or BFA provide better results than a contested court battle, and of the two, a BFA is generally preferable because:

- There is the option to negotiate.
- Advisers can provide appropriate advice.
- Tailored/optimum planning strategies are possible not just in value but also in asset selection and timing.
- Can be proactive – put in place prior to formalising or during a relationship. However, it should be noted that a superannuation agreement made in contemplation of marriage or a de facto relationship is not effective until the relationship is established.
- while there is no need for court assessment, both parties must each get legal advice.

Under a Consent order, while the parties agree on the split and other details, the court will assess if the order is “just and equitable”. This can be done in chambers rather than at a formal court hearing so can be a more practicable and cheaper option than the contested court route.

If all else fails, the matter can go to Court as a “Contested Family Court” hearing at which stage the court implements the following four stage process:

1. Identifies and values all the assets and liabilities of the couple.
2. Assesses the contribution each partner has made towards the total wealth. The contribution is not based only on monetary factors, but rather the court endeavours to consider activities such as child rearing and home making.
3. Attempts to considers any disparity in each partner’s financial situation e.g., career or future earnings impact of having a family and adjusts for this as it feels is justified.
4. Finally, checks to see if the result, in the courts view – not the individual’s - is “fair”.

Looking at BFA’s

BFA’s have increased in popularity in recent years. A BFA can be used to specify how a couple’s assets are to be split should the relationship break down thereby providing greater certainty into the future and allowing such decisions to be made at a time of emotional stability and rationality. While initially there may have been some doubt about the effectiveness of a BFA, the fact that the Family

Law Act has strict guidelines covering BFA's has boosted confidence in them and there seems to have been an increasing use of BFA's. The Family Law guidelines include:

- That each party has obtained independent legal advice.
- A written statement that independent advice was obtained must be provided to the other party.
- The BFA must not have been terminated or set aside by the court.

A BFA can be made to cover only a member's superannuation interest. In this case, it is referred to as a "superannuation agreement". Such an agreement would need to set out the split in terms of either a specified base amount (or formula for calculating the amount) or a specified percentage value. A BFA or superannuation agreement can have many advantages including:

- Increased degree of certainty of how assets will be distributed.
- Potential for better or fairer outcomes as decisions are made during an emotionally stable and rational period of the relationship.
- Potentially less costly outcome as court may be avoided.
- Assets bought prior to the relationship can be quarantined.
- While a BFA can be made prior, during or after the commencement of a relationship, a superannuation agreement made in contemplation of marriage or a de facto relationship is not effective until the relationship is established.

Who, what and how to split

From the legal perspective, the spouse with the superannuation benefit to be split is known as the "member-spouse". The spouse receiving the split benefit is known as the "non-member spouse".

Most super benefits can be split - accumulation, pension and TAP accounts included – and are known as "splitable interests". There are only a few instances where a member super benefit cannot be split – known as "unsplittable interests" – which are:

- Accumulated accounts less than $5,000 or non-commutable income streams paying less than $2,000 pa.
- Temporary disability payments for under 2 years.
- Benefits paid under early release compassionate or financial hardship grounds.

There are two methods of splitting superannuation which are normally specified in the BFA or the court order:

Base amount:

- This can be a certain dollar amount: or
- Specify the method of calculation to determine the base amount.
- Notional interest is payable from when the amount is settled to when it is finally paid.
- Most commonly used where the member spouse interest is in accumulation or a pension that can be commuted.

Percentage split:

- Based on an agreed percentage of the member spouse interest.
- Can be used when the member spouse interest is in accumulation e.g., 50% of the member spouse interest is to be transferred to the non-member spouse.
- Can also be used in the case of non-commutable pensions e.g., 50% of member spouse pension payment is to be paid directly to the non-member spouse.
- No need for notional interest as the percentage split will be applied to the valuation at the payment date.

Tip:
Each method may favour a different spouse depending on the circumstances and this may be where advice can be important. For example, a rising market will generally favour the member spouse where there is a base amount nominated and then a substantial value increase between the agreement date and the finalisation of the split. However, in a falling market, the member spouse would generally prefer a percentage split as the reduced value over time is shared in proportion via the percentage mechanism.

Although not as common as base and percentage splits a flagging order may be made by a court. This prevents the trustee from paying out that part of a member-spouse’s splittable interest until either the parties enter into a written agreement or the Family Court makes an order that the trustees can pay out the benefit. Flagging orders are most commonly used when the member-spouse is close to meeting a condition of release or it is difficult to determine the value of the benefit at the time the order is made.

The role of the fund trustee

Under the superannuation splitting law, a trustee of a superannuation fund is required to provide information to an eligible person if a request by the applicant meets the prescribed requirements.

An eligible person is:

- The member or the spouse of the member
- If the member or spouse has died, the respective legal personal representative (LPR), or
- The person who intends entering into a superannuation agreement with the member.

The request must be in writing with a declaration in the prescribed form - known as a Form 6 Declaration, along with the Superannuation Information Request form plus any requisite fee that may be applicable. Generally, the Form 6 provides information to assist in the negotiations and implementation of a BFA or relevant agreement. Fund trustees must usually provide the following information:

Accumulation funds:

- If any part of the superannuation interest is un-splitable,
- Any interest already subject to payment split or payment flag,
- When member joined the fund, and
- Information about value of the interest (if in pension phase, type of pension).

Defined benefit interest:

- Same as above.
- Complications can arise with some of the valuations (some funds may provide calculations in accordance with Family Law Superannuation Regulations).

Self managed superannuation fund:

- If in pension phase, type of pension being paid, its value and duration.
- Valuations of some assets may not be accurate or reflect the true current asset value e.g., real property investments may not be valued every year.

Acting in a timely manner is important

As any superannuation agreement becomes ‘operative’ at the start of the 4th business day after serving notice on the trustee, and once operative, the trustee cannot make any payment without considering the payment split, it is imperative to serve notice as soon as possible to protect the interests of both parties.

If already separated, serve a copy of BFA or consent order to the fund trustee as soon as possible and if not, serve a copy as soon as separated.

Additional information that will need to be provided at that time include:

- A copy of decree absolute if already divorced.

- A separation declaration if separated but not divorced or de facto relationship has ceased.
- Certificate that independent legal advice has been taken by the parties involved.

Once the non-member spouse entitlement becomes payable – i.e., a court order or a BFA is enforced - the trustee must notify the member spouse and non-member spouse within 28 days that the interest is subject to a payment split.

The non-member spouse and the member spouse then have 28 days after receiving the notice to request any of the three options available (see below) regarding how the non-member spouse's entitlement is to be received.

Finally, the trustee must confirm implementation of the request.

Payment of non-member spouse's entitlement

There are 3 options for how the non-member receives their split interest:

1. Create a new and separate interest in the same fund for the non-member spouse interest.
2. Roll over the interest to a different fund.
3. Receive as a lump sum – only possible if a condition of release with a nil cashing restriction has been met by the non-member spouse or the member account to be split consists of unrestricted non-preserved (UNPB) benefits.

Where there is no valid option chosen, the trustee may decide and choose one of the available options -e.g., create a new interest to accept the split into the same fund. If the trustee decides to roll the non-member spouse's entitlement out of the fund, the trustee must provide a written notice to the non-member spouse providing them with 28 days to nominate a destination fund before their entitlement is transferred to the ATO.

Tip:
While all these options are available, in the case of SMSF's it is generally not recommended that the separating spouses continue to share the same fund as both will need to remain as trustees, and this may prove difficult for the making of rational and harmonious trustee decisions and carrying out their normal trustees responsibilities.

Tax and preservation issues:

At a personal level, the transfer of the non-member spouse interest, whether within the same fund or to a new account in a different fund, is a roll-over benefit. As such:

- There are no personal tax consequences upon receipt of the split interest.
- Will be treated as a normal member benefit in its own right and subject to all the normal tax rules.
- If able to access the benefit either directly on payment of the split or at a later date after rollover, normal tax rules apply.

At the fund level, the following applies to the non-member spouse interest:

- Tax free/taxable proportions - Inherits the proportions of the member spouse benefit:
  - The tax free/taxable proportion is calculated immediately before the payment is made.
- Preservation - Non-member spouse's UNPB is based on proportional basis of member spouse's amount at the time of the split.
- Eligible service days are recorded as "zero" – i.e., the non-member spouse does not inherit the member spouse's eligible service date. The non-member spouse's eligible service date will continue and apply to the split interest.

- Transfer balance account (TBA) – only recorded if non-member spouse's benefit is in retirement phase (e.g., commencing a pension):
  - Commutation (partial or full) of member spouse benefit will be a TBA debit in the normal way.
- Total super balance (TSB) – transfer of, and receipt of split interest will result in a change in the value of each member's TSB when the benefit is transferred.

Tip:

Caution may be required when rolling over the split amount as it will carry across the tax free/taxable proportion of the member spouse benefit and will "contaminate" the non-member spouse interest accordingly. It would be prudent to investigate this impact prior to mixing the interests.

Super CGT implications

A rollover of superannuation assets between funds is normally a CGT event with any CGT liability arising in the source fund. However, there may be CGT relief on the transfer of superannuation assets because of a marriage or relationship breakdown depending on the type of fund in which the interest is held.

The is no CGT relief upon rollover of non-member spouse interests from a retail superannuation fund. In this case, the CGT crystallises in the member spouse account and the non-member acquires a new cost base going forward.

However, where the member spouse interest is held in an SMSF, CGT relief applies where the SMSF interest is split and the CGT asset is transferred/rolled over to a complying fund. In this case, the original cost base of the asset is transferred to the transferee spouse with any capital gain or loss realised only on subsequent disposal.

Where both spouses are in the same SMSF, the CGT relief is only available if the transfer results in the departing member having no further interest in the SMSF. This could be either the member or non-member spouse.

Conclusion – Understanding where you can add value

Divorce is both complex financially, distressing emotionally and brings forward the need to review and reshape the individual's future going forward.

There are many areas where an adviser can add significant value:

Recognising and accounting for the 'real net value' of the asset:

- After tax value important – main residence more valuable than super portfolio (with capital gain) of same value
- A pre-CGT investment property as valuable as a main residence.

Personal lump sum tax considerations:

- Superannuation lump sum payments to spouse under age 60 will not be tax free
- Similarly with split pension payments (although a TAP can be split for a lump sum)
- Therefore, may be worth more to a spouse who is retired and over 60, so may need to negotiate accordingly.

Other consequences of super split:

- Impact on mixing the tax free/taxable components
- Transfer balance cap and total super balance issues
- CGT impact on member spouse account
- Centrelink impacts
- Overall tax position of the spouse.

Generally, financial advisers are better placed (than say lawyers) in selecting tax effective assets, exploring tax effective strategies both now and going forward, and should therefore be involved as part of the divorce negotiation process to ensure optimum results for the client.

An ally, a stronger bond

An ally, a stronger bond

Investment bonds (aka insurance bonds) are provided through insurance companies and friendly societies and are often described as a cross between an insurance policy and a managed fund - the investments are held and structured through a life policy with a policy owner, a life insured and nominated beneficiaries. Investors choose from a range of managed investment portfolios, which is taxed internally at the life company rate of 30%. The policy owner may nominate a beneficiary(s) in the event that the life insured dies during the investment term.

They are a relatively simple investment structure and because the tax is paid by the product provider, the bond owner has no requirement to report annual income and capital gains in their personal tax return. Investment bonds have undergone somewhat of a revitalisation in recent years which may make them a viable addition to an adviser's strategic tool kit.

In the past, they were plagued by limited investment options and relatively high fee structures making them unpopular by comparison to alternatives such as superannuation. This was despite the investment bond offering significantly more flexibility, accessibility, and effective estate planning options.

The modern investment bond has many more investment options – Generation Life for example has nearly 50 options available to choose from over a full range of asset classes managed by some of the biggest investment houses in Australia and internationally. It is effectively a managed fund platform offered under the investment bond structure. Further, the fee structures have been reduced and are now competitive with many managed funds.

It is fair to say that the modern investment bond has earned a place to be considered an effective investment structure from several technical angles:

- It could compliment superannuation.
- Is adaptive to varying demographic groups.
- Has fewer legislative constraints which promotes product flexibility such as death benefit guarantees and flexible beneficiary nominations.

Comparing investment bonds to superannuation

As always, there are advantages and disadvantages (the good and bad) to each:

Not so good features in comparison:

- Tax at 30% instead of (super)15% or ultimately 0%.
- No tax concessions on 'contribution' – all after tax money invested.
- No concessional Centrelink treatment – always treated as financial investments.

Good features in comparison

- Not locked in, no preservation age or conditions of release.
- No contribution limits (other than observing the 125% rule when adding to same bond), no work test or age limits.
- May be used as security against loans.
- No TFN required.
- Not as many complex tax and legislative considerations when passing on investment to beneficiaries.
- Overall, less complexities and less changes (so far) impacting the bond structure.

Tax and withdrawals – how it all works

Investment bonds are a described as a tax paid investment. This means that the investment provider pays tax on investment earnings and realised capital gains internally at the life company rate of 30%. This results in there being no impact on the individual tax return.

The usual franking credits and other applicable deductions are used to reduce the effective tax rate in much the same way as an individual taxpayer would. However, as the tax rate is capped at 30%, this can be an important

consideration whether to invest or not depending on whether their individual tax rate is higher or lower than the 30% bond tax rate.

Withdrawals can be made at any time with possible tax consequences for the bond owner depending on for how long the bond has been held. While the proceeds of any withdrawal are "tax free" if paid out after 10 years of the bond commencement, there are tax consequences if withdrawn within the ten-year period with a portion of the investment growth included in the individual's assessable income as summarised in the table below. However, a 30% non-refundable tax offset is available on any assessable portion recognising the tax already paid by the life company.

Withdrawal	Amount of growth included in individual's assessable income
Within 8 years	Full amount
Between 8 and 9 years	Two thirds
Between 9 and 10 years	One third
After 10 years	None

Thus, after the 10-year anniversary has passed, the total proceeds of the investment bond – including growth – is available with no personal tax consequences. Hence, the view that they are available "tax free" or more correctly noted as tax paid up to 30%.

Tip:

Tax paid and tax free often seem to get confused when considering investment bonds. Even after the 10-year anniversary has past, investment bond earnings and capital gains are still taxed at 30%. It is simply that after this date, any growth component of the withdrawal is not added to the individual's assessable income -i.e. there is no tax consequence for the investor.

This is a tax paid, not a tax free, return on the investment.

Contributions – how it all works

It is possible to make additional contributions to the investment bond within the 10-year period and have those additional contributions participate under the original 10-year period rule – i.e., still be tax free after 10 years.

However, this is subject to what is known as the 125% rule.

Under this rule, additional contributions in any one year must not be more than 125% of the previous year's contribution. This is a rolling rule that looks at the previous year's contribution, not just the previous contribution.

If breached, the commencement date for the whole bond restarts for the purposes of the 10-year rule. For example:

- If $10,000 is invested in one year, then $12,500 can be added the following year.
- If $0 contribution made for one year, then no further contributions can be made the following or any future year without restarting the 10-year period.

Other considerations

Investment bonds come with several other useful characteristics and options including:

Tax considerations

- Ownership (not the life insured) of the bond is able to be transferred to another person.
- No CGT if switched between investment options or transfer ownership of the bond.
- Upon death, can be paid to LPR or beneficiary with no tax impact, irrespective of the 10-year rule.

Estate planning considerations

- On death, bond (as a life policy) is payable to policy owner or nominated beneficiary (no dependants requirement as there is in superannuation).
- If paid to a nominated beneficiary, it will not go through the estate (an advantage if the will is challenged).

Centrelink considerations

- Considered financial assets, with full account value asset tested and income deemed.
- Can be structured under a discretionary trust so that deemed income is avoided but still assessed under the assets test.

Calculating the assessable growth value

If a withdrawal is made prior to the 10-year anniversary, a portion of the growth on the bond is included in the assessable income – as explained in the previous table. There is also a 30% non-refundable tax rebate to recognise the tax paid by the insurance company.

The assessable portion of the growth is calculated as follows:

$$\left[\frac{\text{withdrawal value}}{\text{current bond value}}\right] * \left[\left[\text{bond value} + \text{previous withdrawals}\right] - \left[\text{contributions to date} + \text{previous amounts included in assessable income}\right]\right]$$

The result of this calculation is then multiplied by the assessable percentage (depending on the years of ownership) as per the previous table.

A worked example:
Joe contributes $1,000 per annum for 8 years to his investment bond. In the 8th year, the bond is valued at $15,000 and Joe withdrew $5,000. As the withdrawal happens in the 8th year, two thirds of the growth will be assessable to individual tax.

- Joe calculates as follows: $5,000/$15,000 X ($15,000 + $0) – ($8,000 +$0) = $2,333
- Two thirds of the gain will be assessable: 2/3 x $2,333 = $1,555 included in his tax return
- A non-refundable offset of 30% x $1,555 = $467 is available against his tax liability for that year.

Conclusion

Investment bonds have re-invented themselves and are now really a pseudo managed fund offering a large range of investment options structured under the life insurance rules. In the case of many of the products available, the fee structures have also reduced significantly thereby aligning them more closely with traditional managed funds and making them more competitive.

While super is probably still going to be the preferred initial option for most, investment bonds are now an option to run in parallel with super or as a top up where the individual's superannuation caps are maxed out. Investment bonds have a high degree of flexibility and accessibility and simplicity that in many ways outshines superannuation, but it must be remembered that they are tax paid – not tax free – investments and even after the expiry of the 10 year period, investment earnings will always be taxed at 30% on-going. With superannuation's concessional tax rate upon contribution, over accumulation and at retirement, it is still most likely going to be the primary retirement saving and tax driven vehicle.

As such, investment bonds are unlikely to be a replacement for superannuation but should be seen as a strong medium to long term ally to superannuation. They certainly offer several benefits around accessible tax effective saving plans, estate planning and planning for individual on tax rates higher than 30%.

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A super savvy TPD payout

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Insurance: A super savvy TPD payout

Clients who suffer an injury so severe that it triggers their total and permanent disability (TPD) insurance policy often need to be able to access cash lump sums and/or put in place an income stream. At the same time, they are often not in a strong position to make the most effective decisions and this is where a good adviser can add some real value.

TPD policies can be structured in or out of a member's superannuation fund. This paper deals only with policies structured through a members superannuation account and how to deal with the proceeds once the policy is triggered and policy proceeds paid to the member's account.

Much of the complexity in this area arises because of the need to deal with both the taxation legislation and superannuation legislation (and regulations) as they apply to TPD payments, how they interact with each other, and its application over multiple funds. They are separate pieces of law and must be applied separately to the same benefit sometimes repeatedly if the benefit moves to different superannuation providers. Just to add to the complexity, there can be "grandfathered TPD policies that that will have different limitations to non-grandfathered policies."

The jargon also changes over the various pieces of legislation – total and permanent disability (TPD), permanent incapacity (PI), and permanent disablement. Essentially, they are all referring to same situation - dealing with a member who because of their ill-health (whether physical or mental) makes it unlikely that the member will engage in gainful employment for which the member is reasonably qualified by education, training or experience.

Behind the scenes

Where an insurance policy is established and paid for from the member's superannuation account, any proceeds resulting from a successful claim must be paid into the member's superannuation account. If the member needs to access the account, which includes the TPD proceeds and any accumulated balance, the member must meet a suitable condition of release (CoR) with a nil cashing restriction to convert benefit from "preserved" to unrestricted non-preserved" (UNPB) thereby allowing the benefit to be cashed at any age.

Within superannuation, it has not been possible to establish a new "own occupation" TPD policy since 1 July 2014. Under the Superannuation Industry (supervision) Regulations (SISR), a trustee of a regulated superannuation fund must not provide an insured benefit in relation to a member unless the insured event is consistent with a condition of release specified in SISR Schedule 1:

- Death (nil cashing restriction)
- Terminal medical condition (nil cashing restriction)
- Permanent incapacity – TPD (nil cashing restriction)
- Temporary incapacity (certain conditions apply).

Under SISR, a member of a superannuation fund or an approved deposit fund is taken to be suffering permanent incapacity if a trustee of the fund is reasonably satisfied that the member's ill-health (whether physical or mental) makes it unlikely that the member will engage in gainful employment for which the member is reasonably qualified by education, training, or experience.

Thus an "own occupation" policy is too narrow to meet this definition making it inconsistent with SISR and therefore unable be provided via superannuation.

However, "own occupation" policies established prior to 1 July 2014 and maintained consistently since, are grandfathered, and may continue to be provided via the members superannuation account. So, it is possible in some situations, a member might meet the insurer's definition of TPD under an 'own occupation' definition, resulting in the proceeds being paid to the members super account, but, because the policy is not consistent with the TPD definition, the CoR is not met, and super benefits may be preserved and not accessible until another CoR (other than permanent incapacity) is met.

Benefits received into the initial fund

Let us first consider the process of receiving the policy proceeds into the fund and the various implications.

- It forms part of the taxable component (taxed element).
  - Given that a TPD policy can be for a significant amount, the receipt of a large taxable component

(taxed element) may skew the tax free/taxable proportion towards a higher taxable amount.

- It is immediately preserved.
- To provide access to the money, the member must meet a CoR with a nil cashing restriction:
  - In this case, will normally be the permanent incapacity CoR under SISR 103.

SISR 103:
A member of a superannuation fund or an approved deposit fund is taken to be suffering permanent incapacity if a trustee of the fund is reasonably satisfied that the member's ill-health (whether physical or mental) makes it unlikely that the member will engage in gainful employment for which the member is reasonably qualified by education, training or experience.

- Note that it is the trustee that must be satisfied – there are no specific guidelines set out in the SISA or SISR so each fund trustee may have different criteria to meet this requirement.
- Once satisfied, the benefit amount as at that date becomes UNPB and can be cashed as a lump sum or pension at any time. There may be significant tax implications to consider because of the TPD proceeds as the member may well now have a large taxable component as part of their benefit.

The tax rules

For lump sums, the normal tax rules apply to cashing the benefit – i.e., exiting super or rolling over:

- Tax free component is always tax free.
- Actual tax is dependent on the individuals age (see table).
- Low-rate cap applies between preservation age and 59.
- **Special rule -** For a disability superannuation benefit, the tax free component is increased to reflect the lost future service period where cashed out of super as a lump sum or rolled over (see below); and
- There are no tax consequences upon rolling over.

For pensions, the normal tax rules apply unless the pension is paid from a disability superannuation benefit as defined under the tax laws. If so, for those under preservation age the taxable proportion of the pension is taxed at the individuals marginal tax rate but comes with a 15% rebate. The table below summarise the tax rates that apply:

1 Lump sum tax rate

Age	Tax free component	Taxable component (taxed element)
Age 60+	Nil	Nil
Preservation age to 59	Nil	Up to low rate cap# - Nil
Preservation age to 59	Nil	Above low rate cap# - 15%
Below preservation age	Nil	20%

Low rate cap $215,000 (FY 20/21) & Medicare levy may apply

2 Income stream tax rate

Age pension payment received	Tax free component	Taxable component (taxed element)
Age 60+	Nil	Nil
Preservation age to 59	Nil	Marginal rate less 15% rebate
Under preservation age	Nil	Marginal rate no rebate
Under preservation & disability super benefit	Nil	Marginal rate less 15% rebate

Medicare levy may apply

Lump sum TPD disability superannuation benefit

As can be seen from the above notes, there are significant benefits once it is accepted that the member benefit meets the conditions of a disability superannuation benefit:

- On cashing as a lump sum - including cashing to roll over – the tax free component of the benefit is increased for the future service benefit – broadly reflecting the period where they would have expected to have been gainfully employed; and
- Where taken as a pension, a 15% tax rebate on the taxable component of the pension payment is available below preservation age.

The conditions to meet to become a disability superannuation benefit to take advantage of these modifications are defined in the tax legislation as:

5. The benefit is paid to an individual because he or she suffers from ill-health (whether physical or mental); and
6. Two (2) legally qualified medical practitioners have certified that, because of the ill-health, it is unlikely that the individual can ever be gainfully employed in a capacity for which he or she is reasonably qualified because of education, experience or training.

Note that while similar to the condition of release definition in the SISA, there is no trustee discretion allowed and the requirements are quite prescriptive requiring two medical certificates. It should be emphasised that they are two entirely separate tests, one to allow the payment from superannuation to be made upon meeting the condition of release and the other from the tax point of view, an increase in the tax-free component when paid out as a TPD lump sum (including when rolled over to another fund).

Modification for TPD lump sum

The modification to uplift the tax free component must be done by the fund trustee that is processing the exit or rollover. It cannot be processed by the receiving fund.

If a person receives a lump sum disability super benefit, the tax-free component of the benefit is increased for the future service benefit is as follows:

$$\text{Existing tax free component} + \text{Amount of benefit} \times \left[\frac{\text{Days to retirement}}{\text{Service days} + \text{Days to retirement}} \right]$$

Where:

- **Existing tax free component** is the sum of the tax-free component of the benefit worked out apart from using the disability formula.
- **Amount of benefit** is the sum of the disability benefit being paid, including any insurance proceeds.
- **Days to retirement** is the number of days from the day on which the person stopped being capable of being gainfully employed to their last retirement day (generally age 65).
- **Service days** is the number of days in the service period for the lump sum. Service days is the number of days from the day the member joined the fund or, if a rollover amount was received by the fund with an earlier service period start date, that earlier start date to the date of disability.

The result of this calculation is the tax-free component. The balance of the account is taxable component.

The impact of this modification can be quite dramatic and highly beneficial to the client. For example:

John's case

John is 35 years old and has just received a $2m TPD pay out from the insurance company to his member account. He had $50,000 in super prior to the TPD payout.

The details are as follows:

Portion	Component	$	%
Own super balance	Tax free	$5,000	0.24%
	Taxable	$45,000	
PI insurance payment	Taxable	$2,000,000	99.76%
		$2,050,000	100.00%

Period	Years	Days
Service days - to date disability occurred	5 years	1,828
Days to retirement - date of disability to age 65	30 years	10,965

John's adviser suggests that he rollover to another provider to get the tax-free uplift. John satisfies the fund trustee that he meets the tax definition of TPD and the trustee confirms that the exit (roll over) will be a lump sum disability payment.

- The modified tax-free component is calculated as follows: $5,000 +($2,050,000 x 10,965 / (1,828+10,965) = $1,762,074

The result is as follows:

After tax free uplift	Component	$	%
Combined benefit	Tax free	$1,762,074	85.95%
	Taxable	$287,926	14.05%
		$2,050,000	100.00%

Tip:
Remember that commencing an income stream from the original fund does NOT result in a lump sum withdrawal and therefore there is no modification or resultant tax-free uplift. Consideration should be given to rolling over to a different fund prior to commencing an income stream.

Rolling over to a new fund – follow the process to get the benefits

In order to achieve the full range of benefits – accessibility and tax efficiency –both the SIS and ATO requirements must be met.

Firstly, within the initial fund that received the TPD payment, the member must satisfy the SIS TPD requirements for access. Once the trustee is satisfied these TPD conditions are met, the value of the member account as at that date becomes unrestricted non-preserved (UNPB). This means that the member may cash the benefit up to that value as either a lump sum or a pension at any time. At this point, and if the benefit remains in this fund, the tax free uplift is not available.

Therefore, the second step to consider is to rollover the benefit to a new fund. The rollover creates a lump sum benefit and triggers the tax laws into operation. On meeting the ATO TPD requirements (as assessed by the trustee of the initial fund), that fund calculates and applies the tax free uplift on any lump sum benefit paid out of the fund.

The receiving fund simply accepts the rollover from the initial fund. The UNPB and uplifted tax free components carry across with all the other member information. The receiving fund is not informed that it was a TPD benefit in the previous fund – it simply accepts the data provided from the initial fund.

Can the member cash the benefit in the receiving fund?
Yes, as either a lump sum or a pension up to the UNPB balance transferred from the initial fund. The normal tax rates are applied depending on the members age with the benefit of the tax free uplift.

If a pension is elected, is it automatically a disability income stream with the 15% rebate on the taxable proportion of the payment?

No, because the disability status from the initial fund does not carry across. To be eligible for the 15% tax rebate, the trustee of the receiving fund must be satisfied that the member meets the ATO TPD requirements (member will unfortunately have to go through a similar TPD assessment process again with the receiving fund for this to happen).

To illustrate this strategy using the facts of the case study above where the original fund accepted John is disabled and his account became UNPB. John does not need an immediate lump sum but wants a steady income stream with the occasional lump sums.

There are two advice options, as an adviser:

1. Stay with the existing fund and begin an income stream noting that there is no tax free uplift as the income stream remains in the initial fund. There has been no cashing event by way of a lump sum to trigger the tax free uplift. However, the trustee has acknowledged that John is TPD and will apply the 15% rebate to the taxable portion of his pension payment.

2. Rollover to another fund and then commence an income stream. With the rolling over of the account balance and the UNPB transferred to a new fund, the paying fund trustee will /should apply the tax free uplift on the lump sum rollover payment. Once rolled over to the new fund and as a separate exercise - John needs to prove to the new fund trustee that he is TPD to get the 15% rebate on the taxable portion of the pension payment – more paperwork for you and John.

However, the results can justify the exercise!

	Taxable/ tax free split	Account value	Pension	Tax free	Taxable	Tax & Medicare payable	Net amount
Option 1 – Initial fund	99.76% / 0.24%	$2,050,000	$82,000	$200	$81,800	$ 18,688	$63,312
Option 2 – Rollover to new fund	14.05% / 85.95%	$2,050,000	$82,000	$70,483	$11,517	$ -	$82,000

Other strategic considerations

Advisers should also be aware of the following points when working with clients:

- Different trustees will have different requirements to satisfy the SIS condition of release. In the case of Netwealth, the requirements are that 2 legally qualified medical practitioners have certified that, because of the ill-health, it is unlikely that the individual can ever be gainfully employed in a capacity for which he or she is reasonably qualified because of education, experience, or training. The medical certification must be less than 18 months old.

- Netwealth allows "pre-approval" of the medical certification in order to smooth the rollover process and provide certainty going forward.

- Other strategies and impacts should also be considered in conjunction with TPD rollovers. For example, for someone below preservation age, consider drawing the minimum pension at say 4%, and if any supplemental or higher withdrawal is needed, whether it is more beneficial to take it as an additional pension (with taxable portion assessable at marginal tax rate but with a 15% rebate) or a partial commutation as a lump sum (with taxable portion assessed at 20%) from the pension is a better tax option. Of course, this will very much depend on the tax free/taxable components and the individual's other income (if any) so some analysis will be required to determine the optimal outcome.

- Starting a pension immediately after rollover (for the tax free uplift) will lock in the tax free/taxable components for future earnings and growth. Also, any future growth in the income stream will remain unpreserved.

- Finally, do not forget to consider any TSB, TBA and TBC implications.

Conclusion

There is potentially a lot more to dealing with TPD payments than appears at first glance and the astute adviser can add significant value for the client. The key points to remember are:

- Be aware that there may be grandfathered TPD policies from pre 2014 that can result in benefits being preserved. Post 1 July 2014, only new "any occupation" TPD policies can be structured in super.

- TPD policy proceeds paid to super accounts form part of the taxable component.

- TPD proceeds are preserved until a CoR is met:
  - Meeting the CoR to unpreserved benefits does not change the tax free/taxable proportions.

- Once a CoR is met it is accessible to be cashed as either a lump sum (exit super) or lump sum rollover (to a new fund) or commence an income stream.

- A tax free uplift recognising future service to age 65 is available when cashed as a lump sum (upon exit or rollover):
  - An income stream in the original fund does not result in a lump sum payout and no tax free uplift is available.

- To get the benefit of the tax free uplift applying to an income stream, the member account must be rolled over to a new fund and the income stream commenced with the new fund.

- A 15% rebate on the taxable proportion of the income stream is available below preservation age if the trustee accepts the member is TPD under the tax definition:
  - Accepting member as TPD for the 15% rebate is a separate exercise to meeting the TPD CoR to unpreserved the funds.

Sharpening the tools of the trade

Sharpening the tools of the trade

Every professional needs to have a range of tools at their disposal in order to best help their clients achieve their objectives. Having the tools is one thing but, understanding how to use them effectively is just as important if a successful outcome is to be achieved.

Our profession is no different in that advisers need their tools – often intellectual tools - and they need to know how to use them to best effect. This often involves understanding the interactions between tax, superannuation and the myriad of changes that have evolved over the years.

The financial planning profession would almost be unique in its level of complexity, interconnectedness and scope of expertise that is demanded of the successful practitioner. This is no more true than right now as we face trying to understand how to apply, and what implications and opportunities are likely to flow, from the indexation of the transfer balance caps (TBC) and the concessional contributions cap from 1 July 2021.

Building blocks of superannuation

Building client's super assets starts with the basic tools of the trade - concessional and non-concessional contributions. It is strengthened and cemented over the longer term with compulsory contributions (SG) and earnings. Add on the odd bonuses such as foreign pension fund transfer in, government co-contributions, and possibly payments from unexpected insured events such as TPD and death and it becomes the single most important saving vehicle for most people.

As always, there are building obstacles to overcome – primarily the various caps:

- Concessional contributions cap (CC)
- Non-concessional contributions cap (NCC)
- General transfer balance cap
- Personal transfer balance cap
- Total super balance (TSB)

Initially perceived as forced savings, superannuation is now looked at as an effective tax driven vehicle, often the next best tax shelter option after the main residence and this has cemented its place as a major wealth creation solution for many people. With SG contributions ramping up to 12% from 1 July 2025, this trend is likely to continue.

However, for accessing one of the most tax effective structures, there is price to pay - lots of regulations and complexities!

Having a strong understanding of the superannuation rules and utilising these various tools from start to end, it is possible to create clever and very sharp planning scenarios and strategies to better meet client objectives!

So what are the changes?

Indexation of the transfer balance cap

The general transfer balance cap is currently $1.6 million. From 1 July 2021, it will be indexed in line with the consumer price index (CPI) with a $100,000 increase to $1.7 million.

When the general transfer balance cap is indexed to $1.7 million, there will not be a single cap that applies to all individuals. Every individual will have their own personal transfer balance cap of between $1.6 and $1.7 million, depending on their circumstances.

If an individual starts a retirement phase income stream for the first time on or after 1 July 2021 (ie never had a transfer balance account before this date), they will receive the full indexed $100,000 increase and will therefore have a personal transfer balance cap of $1.7 million.

If they had a transfer balance account before 1 July 2021, only the unused portion of their personal transfer balance cap is indexed and therefore it will be:

- remaining at $1.6 million if, at any time between 1 July 2017 and 30 June 2021, the balance of that account was $1.6 million or more (as 100% of their $1.6m cap has been fully utilised and therefore not entitled to any part of the increase)
- between $1.6 and $1.7 million in all other cases, based on the highest ever balance of the individual's transfer balance account (only entitled to part of the $100,000

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increase based on the percentage of the $1.6m cap not utilised) – see further explanations below.

Where an individual has never used the full amount of their transfer balance cap, the personal transfer balance cap will be proportionally indexed based on the highest ever balance of the individual's transfer balance account.

It is calculated by:

- Identifying the highest ever balance in the transfer balance account;
- Using that to work out the unused cap percentage of the transfer balance account;
- Multiplying the unused cap percentage by $100,000.

The unused cap percentage is calculated as follows:

$$\text{Unused cap percentage} = \left[100 - \left[\frac{\text{Highest ever TBA}}{\text{TBC on the 1}^{\text{st}}\text{ day you had a TBA}} \right] \times 100 \right]$$

Example

- Nina started a retirement phase income stream with a value of $1.2 million on 1 October 2018.
- There are no other events in Nina's transfer balance account. The highest ever balance in her transfer balance account is $1.2 million.
- 100 – (($1,200,000 / $1,600,000) X 100) = 25
- Nina's unused cap percentage is 25% of $1.6 million.
- Nina's personal transfer balance cap will by indexed by 25% of $100,000.
- $100,000 x 25% = $25,000
- $1,600,000 + $25,000 =$1,625,000
- Nina's personal transfer balance cap after indexation on 1 July 2021 is $1.625 million.

Note:
Individuals should be able to confirm their transfer balance cap information with ATO Online Services – myGov account (https://www.ato.gov.au/general/online-services/)

Using the ATO service above, before 1 July 2021, individuals can see their highest ever balance in their transfer balance account as well as being able to see if their personal transfer balance cap will be proportionally indexed.

From July 2021, individuals will also be able to see their personal transfer balance cap in ATO online.

This will be the only place they can see their personal transfer balance cap if they had a transfer balance account before 1 July 2021.

What are the benefits of the indexed general TBC

Indexation of the general transfer balance cap to $1.7m increases the thresholds that apply to individuals total super balance (TSB), for the purpose of making (Note: the personal TBC has no consequence here):

- non-concessional contributions to superannuation
- a non-concessional contribution to superannuation and eligibility for a co-contribution
- a super contribution on behalf of a spouse (spouse contribution) and claiming a tax offset.

What are the impacts of the indexed personal TBC

Prior to 1 July 2021, every individual for the purpose of commencing an income stream in retirement phase needs to ensure that their transfer balance account is within the general (which happens to be everyone's personal) TBC of $1.6m.

However, with the changes outlined above, from 1 July 2021 individuals may have a personal TBC ranging from $1.6m to $1.7m depending on their own circumstances thereby departing from the indexed general TBC of $1.7m. With this change, each individual will need to apply caution and check their TBA against their own personal TBC (not just the general TBC as in the past) when commencing an income stream in retirement phase.

Concessional and non-concessional cap increases

Currently, the concessional contributions (CC) cap stands at $25,000. It is indexed on an annual basis in line with AWOTE (rather than CPI) but only in $2,500 increments. This has now been achieved and therefore from 1 July 2021, the CC cap will be $27,500.

The non-concessional contributions cap is determined as four (4) times the concessional cap. Therefore, from 1 July 2021, the new non-concessional contributions (NCC) cap increases from $100,000 to $110,000

This then flows on to the increase in the "bring forward cap" from $300,000 to $330,000.

The change in transfer balance cap to $1.7m and non-concessional contributions cap to $110,000 together alters the bring forward thresholds as follows (from 1 July 2021):

Total super balance on 30 June of the Previous FY	Non-concessional contributions cap for the first year	Bring forward period
Less than $1.48mil	$330,000	3 years
$1.48 million to less than $1.59 million	$220,000	2 years
$1.59 million to less than $1.7 million	$110,000	No bring forward period, general NCC applies
$1.7 million or more	nil	n/a

The carry forward unused CC cap (when in full swing plus annual CC) can provide tax deduction of $165,000 ($27,500 x 6) in a year – however, note that the TSB requirement remain unchanged at $500,000.

These changes allow more contributions to be made and the flexibility of a higher level of tax deduction.

Tips and traps for the unwary

Once the NCC bring forward rule is triggered, individuals are limited to the bring forward cap applicable at time of trigger:

- If triggered in FY20 or FY21, the bring forward cap is limited to $300k until the 3-year cycle is completed.
- There is no composite/transitional cap unfortunately. Therefore, seriously consider not triggering the bring forward non-concessional cap this financial year if it can wait until next financial year with the higher bring forward cap (although watch market volatility that may impact TSB and ability to contribute).

Note:
As the time of writing, the three year bring forward extension to age 67 is still not legislated.

Finally, while not impacted by the indexation mentioned above, do not forget:

- The work test is a separate test to be satisfied to enable contribution to be made and this has been extended and now required to be met only from age 67 onwards;
- Work test exemption is also available allowing contributions to be made and the NCC bring forward rule to operate.

Conclusion

Every professional needs to have a full range of tools in their "kit". Our tools revolve around understanding tax and superannuation law and lateral thinking to use them to create effective strategies to achieve successful client outcomes.

Different tools and skills are required at different times and the upcoming 1 July 2021 changes are a prime example of where a couple of relatively small changes – indexation of the concessional contributions cap and the general transfer balance cap - will have a large number of "knock on" effects for just about everyone from salary earners to retirees.

It is critical to learn, understand and take advantage of the opportunities these two changes will bring both before and after 1 July 2021 to ensure our clients can get the greatest advantage possible given their circumstances.

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