RW NEWSLETTER

Budget 2016 – Simply Super?

Superannuation is a central part of Treasurer Morrison's first Budget. The cunningly crafted changes retain the attractiveness of superannuation as the preferred savings vehicle for retirement whilst making the system far more equitable. There is an improvement in simplicity in some areas.

About 4% of Australians will be worse off through the changes.

Collectively, the changes will drive couples to manage their superannuation together – funds will need to manage joint (family) accounts to stem the continued shift towards SMSFs

In this issue

Proposed Policy Changes

This Budget has introduced the largest changes to superannuation since the Costello Budget of 2006. Arguably, that Budget was far too generous with the creation of unlimited tax-free pensions. This Budget retains the core shape of those reforms while reinstating a degree of equity into the system.

The retention of dividend imputation and concessional taxes on fund earnings still makes superannuation the prime savings vehicle for all Australians. While there is speculation that wealthier Australians will shift to other savings vehicles, perhaps negatively geared, these will remain less attractive.

The proposed superannuation changes all take place from 1 July 2017 apart from the new cap on career non concessional contributions. The latter applies retrospectively from 1 July 2007 and will be monitored by the ATO which keeps records of annual contributions. People who had already made non-concessional contributions of more than $500,000 prior to the Treasurer's Budget speech can no longer make these contributions.

Fiscal Change

There were several measures affecting superannuation which will lead to savings of more than $1 billion a year.

The budget savings ($m) from the various superannuation changes are shown in Table 1. The redistribution of equity can be seen from the revenue raised from each item, mainly from wealthier Australians. This is balanced by the costs of LISTO and the catch up of concessional contributions.

Table 1. Forward estimates of superannuation changes

Reform Item	2015-16	2016-17	2017-18	2018-19	2019-20
Catch up concessional contributions	-	-	-	-100	-250
Harmonising rules for ages 65 to 74			-40	-40	-50
Improve low income spouse payments				-5	-5
$1.6 million pension cap			550	700	750
Lifetime non-concessional cap		50	100	150	250
LISTO (previously called LISC)			-100	-700	-800
Remove anti-detriment on death benefits				105	245
Integrity of income streams (TTR)			190	220	230
Tax deductions for personal super			350	-650	-750
Reformation of the taxation of concessional superannuation contributions			500	800	1150
Total		**50**	**1,550**	**480**	**770**

Objective of Superannuation

The Government has accepted the Financial System Inquiry (FSI) recommendation. The prime objective of superannuation is to ***provide income in retirement to substitute or supplement the Age Pension.*** The objective is unchanged despite the extensive recent consultation with industry about the overall objectives.

There are supplementary objectives too, though life insurance is not one of them. Rice Warner, among others, has argued that group insurance is core to the system and should be recognised as such.

The Government noted that these tax reforms have been designed to fit in with the prime objective of superannuation.

Division 293

From 1 July 2017 the threshold for Division 293 tax will be reduced from $300,000 to $250,000. This threshold is the total of salary and concessional superannuation contributions combined. It is based on Adjusted Taxable Income (ATI) which also adds back components including investment earnings and net investment losses.

Any contributions above the threshold are assessable within the fund at 30% rather than 15%.

This change (which mirrors Labor Party policy) recognises that those on the top personal marginal tax rates receive a larger tax benefit from payment of concessional contributions. There was speculation that this threshold was going to be reduced to those earning $180,000 in salary/super. However, that would have impacted on a much larger part of the population (which is not smart going into an election).

Behavioural change

We do not consider that the change to the Division 293 threshold will have any material impact on behaviour.

Some high-income earners might consider that it is no longer attractive to put money into superannuation. They will still be paying SG contributions of $19,616 next year – not that much below the new $25,000 concessional limit. However, if they put in the maximum concessional contribution in FY2016, they might well reduce this to the SG level from 1 July 2017.

Concessional Caps

The concessional contribution cap is currently $30,000 a year for individuals who have not yet attained age 49 on 1 July of the financial year. For those who are older, the concessional cap is $35,000. Australians who have attained age 65 may make concessional contributions up to age 75 subject to continued employment.

From 1 July 2017, the concessional cap will be a flat $25,000 a year (irrespective of age). This is relatively low – it was $100,000 eight years ago – and the super industry hopes that the reduction will be temporary. Given our Nation's fiscal position, it is unlikely to be reviewed for a number of years apart from indexation. In time, it would make sense to make the concessional contribution cap and the maximum SG contribution the same amount.

This cap will also be available to self-employed individuals. This includes individuals who are mainly self-employed but earn more than 10% of their income from employment remuneration and benefits – and are largely excluded from concessional contributions under current rules.

Effectively, there is now no work test for the payment of any contributions.

Behavioural change

Concessional contributions will still have an advantage, albeit in smaller amounts than before.

Those who currently maximise use of the concessional contributions cap will continue to do so. As the new threshold for older members is $10,000 a year less than the current threshold for those over age 50, individuals will need to decide whether to put the $10,000 into superannuation as a non-concessional contribution, whether to direct it to other forms of savings, or whether to consume it.

We believe that:

- It is likely that many of those who still have home mortgages will simply direct more to paying off the mortgage earlier. This is a form of saving.
- Those who are below the new pension threshold will try to get to that level. They are likely to make non-concessional contributions of between $5,000 and $15,000 a year to maintain the cash flow into their superannuation account.
- Those with significant amounts of superannuation will simply drop to the new concessional contributions cap and make no non-concessional contributions.

Impact

- The reduction in the Concessional Contribution caps and the increase in contributions tax for higher income earners will reduce the net (after tax) contributions being invested in the superannuation system. This will in turn reduce the value of assets held in the superannuation system.
- The reduction in total superannuation assets will not have a material effect on Age Pension outlays.

Catch up on Concessional Contributions

Members **who have a superannuation balance less than $500,000** and who do not contribute the full available $25,000 a year of concessional contributions can save the shortfall for up to five years. This will be attractive for women who leave the workforce to raise a family. On return from maternity leave, they can make good the shortfall.

Although many women will still not have the disposable income to make large contributions, the ability to make personal concessional contributions means they can leverage their partner's salary too.

Personal contributions

The removal of all work tests, the reduction in concessional caps and the cap on individuals' pension balances will create a financial planning opportunity to work with middle income families. It now makes sense for both partners in a couple to build their superannuation towards the $1.6 million pension cap.

A spouse does not need to be employed to make contributions. As long as a spouse has taxable income – and this can come from investment earnings – they can contribute to superannuation. The working partner can divert up to $25,000 into their partner's account as their 'personal contribution'. Of course, people are more likely to set up an SMSF for these arrangements.

Those employees working for businesses which do not allow 'salary sacrifice' can also now make personal contributions. They can supplement their SG contributions up to the $25,000 concessional contributions limit.

Lifetime non-concessional cap

At present, individuals are able to contribute up to $180,000 a year as non-concessional contributions. At any age, they can bring forward three years and make a contribution up to $540,000. These contributions currently cease at age 65 (though it is possible to bring forward three years at age 64 making the effective cap in the last year $540,000).

Effective 3 May 2016 (Budget night), there is a new cap for non-concessional contributions of $500,000 over an individual's lifetime. This will include any non-concessional contributions made since 1 July 2007. This change will replace the annual non-concessional cap.

This cap will be indexed to AWOTE and it will be changed in $50,000 increments.

Note that the current rule for converting the proceeds of a sale of small business into superannuation as non-concessional contributions will continue and will be separate to this cap.

Behavioural change

Many Australians will to continue to pay more than the SG as they try and build large superannuation balances. However, many will need to top up with non-concessional contributions to achieve their goal.

The removal of the annual cap will see some people top up their contributions in excess of the current limit of $180,000 in the first year.

After people reach the cap they will then redirect the excess non-concessional contributions they would have made either to private wealth or housing, or will simply spend the money.

RW NEWSLETTER

Impact

The change to a lifetime cap for non-concessional contributions will reduce contributions being invested into the superannuation system. This will in turn produce a modest reduction in the value of assets held in the superannuation system.

There will be little change to Age Pension outlays.

Cap on pension balances

From 1 July 2017, the total balance an individual can transfer into a pension account will be capped at $1,600,000. If a member accumulates more than this in the superannuation system, they can leave the excess amount in their accumulation account or take it as a lump sum payment.

This cap is reminiscent of the old Pension Reasonable Benefit Limit. Had this RBL been retained, it would have grown to about $2.5 million by now. This was ASFA's recommended threshold for pension accounts so the government has set it at a much lower level – but allowed members to continue with an additional accumulation benefit on top.

This cap will be indexed to CPI and increased in increments of $100,000. Indexation to CPI rather than AWOTE will contain the growth of the threshold.

The cap is a limit on the lifetime amount transferred into pensions. Where a member transfers an amount less than $1.6m into a pension, the percentage of the cap used will be stored. At a later date, they will be able to make additional transfers up to 100% of whatever the pension cap equals at the time the transfer is made. For example, if a member has $800,000 in their pension account at 1 July 2016, this is 50% of the pension cap. If the cap is increased by indexation to $1.7m through indexation, they will be entitled to transfer 50% of this amount, namely $850,000 from future accumulation benefits.

Members with existing pension balance above $1.6 million will be required to reduce their balance back to $1.6 million by 1 July 2017. This can be done by:

- Taking a lump sum or
- Moving the money back to their accumulation account.

Behavioural change

Those members with in excess of $1.6 million in their pension account(s) will need to transfer the excess. We consider most will shift the money back into accumulation rather than taking it out as a pension payment, as the tax rate of up to 15% in concessional contributions is highly favourable compared to standard individual tax rates.

Wealthier couples will target building $3.2 million in pensions by building the benefits of each partner.

Some retirees may find that they can invest more than $1.6 million tax-free, by holding investments in their own name to the extent that they can do so while keeping their income below the personal tax-free threshold.

Impact

The imposition of the cap on transfers to pension phase will lead to a minimal reduction in the value of assets held within the superannuation system. This small reduction is mainly due to the higher tax that will be paid on the assets that will now need to remain within the taxable (accumulation) phase.

Transition to Retirement

Transition to Retirement Income Stream (TRIS) pensions have been used to generate tax-free earnings for many wealthier working Australians. The benefit has been retained but the earnings on assets held in the TRIS pension will now be taxed at the same rate as accumulation funds.

While this change is designed to hit the wealthy, it does impact on middle-income Australians too.

It will no longer be possible to draw certain tax-free lump sums (up to $195,000 in total) from TRIS products. All withdrawals from TRIS accounts will be treated as pension payments.

Behavioural change

Fewer wealthier members will establish these accounts, unless they have already attained age 65 where the benefit will still be tax-free on earnings. In fact, many who currently hold these accounts (if under age 65) will revert to accumulation where they don't need to make the 4% annual pension payment.

Where a married couple has one partner retired from work, there may be arbitrage from shifting money into their account which will have tax-free earnings. Some of this will be done before 30 June 2016 when it is possible to draw tax free income (if age 60 or older) from the TTR account and move it into the pension of the partner who is a retiree as a non-concessional contribution.

Some older people might leave their employment and retire. This will allow them to set up a tax-free pension. It is unclear what would happen if they then restart work later. Does the pension revert to being TTR?

Introduce LISTO

The Low Income Superannuation Contribution (LISC) will not be abolished from 2018 FY as currently planned. LISC is a government contribution payment of up to $500 paid into superannuation to help low income earners save for retirement.

From 1 July 2017, the Government will introduce a Low Income Superannuation Tax Offset (LISTO) which will provide a tax offset to superannuation funds in respect of the tax paid on the concessional contributions of low income earners. The name change allows the Government to maintain its commitment not to reintroduce Labor's LISC.

The offset will be paid to accounts of members with an annual taxable income under $37,000, up to a cap of $500, to effectively refund the tax paid on concessional contributions. This goes a long way towards addressing the fundamental inequity of low income earners paying tax on super contributions at a higher rate than their income tax, while high earners received substantial tax benefits on their super.

It is not clear whether the thresholds for LISTO will be indexed. The LISC thresholds are not, but were anticipated to be raised from time to time.

Behavioural change

We do not anticipate any behavioural change from this policy change.

Impact

The LISTO would increase contributions for lower income earners. The result would be a small increase in total superannuation assets. This increase in assets will have minimal impact on Age Pension outlays because the increases in account balances for low income earners are not sufficient to reduce their eligibility under the means test for the Age Pension. However, it will increase the extent to which super supplements the Age Pension for lower income earners, boosting their standard of living in retirement.

Defined Benefits

Defined benefits are usually an afterthought. This time changes have been made to bring defined benefits (including constitutionally protected public sector funds) into line with accumulation funds.

Members will be subject to the Division 293 limit ($250,000) for the high income contribution tax.

Defined benefit pensions from unfunded arrangements will be taxed at full marginal personal tax rates on pension income above $100,000. For members of funded defined benefit schemes, 50% of pension amounts above $100,000 will be taxed at the individual's marginal tax rate. It would appear that the $100,000 has been derived by assuming a commutation factor of 16 on the new $1.6 million cap.

The Government claims that less than 1% of defined benefit members will be affected. Many of these members are retired politicians, judges and senior public servants.

Retirement Income Products

The Government has extended the tax exemption on earnings to products such as deferred annuities and group self-annuitisation products. The Government will review the impact of these products on the Age Pension means test.

The change is not likely to make much difference to the poor sales of these products.

The government has not yet released its response to the FSI recommendation to set up default retirement products, to be called Comprehensive Income Products in Retirement (CIPRs). These must take longevity into account. However, everyone is grappling over how to develop a standardised product for a heterogeneous group entering retirement. It is possible that CIPRs in some superannuation funds will include an option for deferred annuities with members allowed to opt-out.

Anti-detriment measure

This measure is a legacy one created when superannuation was first taxed in 1988.

On death, it is possible to claw back the tax paid on concessional contributions throughout the member's career.

This is an anachronism and the government has abolished it for deaths occurring after 30 June 2017.

Combined Impact

System level

The combination of all the policy settings can be expected to result in a decrease in total superannuation system assets compared to the expected amounts under the current rules. The primary contributor to this reduction is the reduction in the non-concessional caps. The reduction in the concessional contribution cap is the second largest contributor, followed by the reduction in the Division 293 threshold. However, there is a small compensation from the introduction of the LISTO.

The combination of the policy settings can be expected to lead to a small increase in Age Pension outlays and in the number of Age Pension recipients.

Individuals

The changes will undoubtedly lead to changes in how people use and manage their superannuation.

The cap on transfers to pensions when combined with the concessional cap should see more joint planning for retirement as couples seek to maximise their joint pension assets. This should be positive for women:

- Women with non-employment income will now be able to utilise the concessional contribution cap.
- Couples with the bulk of their pension assets held by one partner (usually the husband) will seek to maximise their pension assets by withdrawing assets from their pension and redirecting them to their spouse's account via concessional and non-concessional contributions. The lifetime non-concessional cap will put a limit on this, but there is still scope for significant rebalancing between partners.
- Where only one partner is making use of a TTR pension with the other fully retired, there will be a further incentive to optimise pension assets.
- Couples have until 30 June 2017 to re-arrange their affairs and we should expect that many will.

The imposition of tax on TTR pension assets is also likely to see an acceleration of people moving to full retirement. What is not clear, however, is the tax position of the pension assets should the retired person re-enter the workforce in a part-time or even full-time capacity at a later date.

The changes may lead to more diversity in savings strategies for wealthier individuals. Someone who would previously have built up a very large SMSF balance might now use a combination of super, direct equity investment, managed funds, investment bonds and properties (perhaps with some use of negative gearing).

Contact Us

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