Revisiting the CGT transitional rules

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Knowledge areas and accreditation

Knowledge area: SMSFs (60 minutes/1.0 point), SMSFs — Legal Environment and Compliance (15 minutes/0.25 points). FPA CPD points: 1.0, Dimensions: Capability, Critical Thinking (FPA 009875). AFA CPD points: 1.25 (AFA 01022009). CPA Australia CPD points: 1.25 (CPA 000490). TPB CPE (75 minutes/1.25 points). SMSF Association CPD Points: 1.25.

Overview

From 1 July 2017, the Federal Government's (Government) new transfer balance cap of $1.6 million is applied to all income streams in the "retirement phase". Transition-to-retirement income streams (TRISs) in the accumulation phase are not subject to the transfer balance cap. By extension of the cap being introduced, this will limit the value of the assets an individual can transfer into a tax-free pension account to $1.6 million.

As a result, those funds paying an account-based pension valued at greater than $1.6 million or a TRIS in accumulation phase prior to 1 July 2017, will lose some or all of that exemption from 1 July 2017.

To soften the impact of this change, the Government provided transitional capital gains tax (CGT) relief measures available to those affected funds for the 2016/17 financial year. These relief measures are not compulsory and are subject to a fund electing for them to apply. Anti-avoidance measures have been incorporated into the relief measures to ensure a fund does not enter into a scheme to avoid tax.

Learning objectives

After reading this article, you should be able to:

- identify when a fund is eligible to apply the transitional CGT relief to its assets and distinguish between a TRIS in accumulation phase versus retirement phase
- differentiate between when a fund is entitled to use the segregated versus proportionate method for applying the transitional CGT relief
- discuss the strategies an SMSF needs to be aware of to ensure it does not create tax avoidance issue as a result of applying the transitional CGT relief
- explain the reporting obligations for a fund that elects to apply the transitional CGT relief.

What is the relief about?

Since 1 July 2017, new taxation rules for superannuation funds have taken effect. Some of these rules have adversely affected the ongoing taxation position of funds paying a pension to their members prior to 1 July 2017, and will impact all new pension commencements for large member balances.

Prior to the implementation of the new taxation measures, a fund paying a pension was entitled to receive a tax deduction to the value of the income received that was attributable to the assets deemed to be supporting the pension payable.

Subject to the fund structure — that is, whether the fund is exclusively paying one or more pensions or whether there is a mixture of pension and accumulation interests within the fund, the fund uses one of, or both — the approved methods for determining how much of the fund income is exempt from tax. These two methods, the segregated method or the proportionate method, are relevant for how the capital gains tax (CGT) relief is applied.

Did you know?

Asset segregation is not always a choice

Identifying specific assets for the purpose of obtaining a tax exemption on the earnings of those assets is a decision for the trustee of an SMSF. A fund that is exclusively paying a pension, so has no accumulation interest, is considered to be using the segregated method.

According to ATO annual SMSF statistics *Self-managed super funds: a statistical overview 2015–16*, as at 30 June 2016, 35.7% of SMSFs were in full pension mode, meaning these funds would be using the segregated method for calculating their tax exemption and applying the transitional CGT relief. An additional 11.4% of SMSFs are partially paying a pension, so would be required to make a choice between segregated and proportionate method (ATO 2018).

Up until 30 June 2017, there was no limit on how much an individual could have in an account-based pension (ABP) or a transition-to-retirement income stream (TRIS), and so there was no limit on the value of the assets that are entitled to this tax exemption. The transitional CGT relief will ensure that tax will not be payable on unrealised gains that have accrued on assets previously used to support a pension prior to the reform taking effect.

The effect of the transitional CGT relief is to reset the cost base of the fund assets, via a deemed sale and repurchase, and in doing so to disregard partially or fully any capital gain attributable to the sale and reset the purchase date for future CGT discounting purposes.

Quicklink

To download the ATO's Law Companion Ruling LCR 2016/8 *Superannuation reform: transitional CGT relief for complying superannuation funds and pooled superannuation trusts* (LCR 2016/8), visit www.ato.gov.au:

› Select "Legal Database"

› Enter "LCR 2016/8" in "Search Legal Database" search field.

Note: LCR 2016/8 was last updated in December 2017 to include numerous updates including changes to TRISs.

Who is entitled to apply the relief?

As identified, the Federal Government (Government) is providing fund trustees with the transitional CGT relief provisions to ensure that tax does not apply to unrealised capital gains that have accrued on assets that have been used to support pensions prior to these reforms. However, not all funds are entitled to the relief and not all assets are eligible for application of the relief. Subject to the circumstances covered in the following discussion, a fund can apply the transitional CGT relief.

Complying with the transfer balance cap

All individuals need to comply with the transfer balance cap from 1 July 2017. For many, this will mean they need to reduce amounts currently supporting an ABP to ensure their total pension assets are no greater than $1.6 million. This will require an overview of all superannuation interests an individual has, with consideration given to current pensions payable, including from defined benefits schemes.

Individuals can comply with the transfer balance cap by withdrawing money from the superannuation environment or transferring excess benefits from the retirement phase to the accumulation phase.

Example

Complying with the transfer balance cap

Cindy is in receipt of an ABP with an account balance of $1.9 million at 30 June 2017. To comply with the transfer balance cap, Cindy's fund would have needed to commute $300,000 prior to 1 July 2017.

As the fund needs to take action to comply with the new cap, it is eligible to apply the transitional CGT relief to its assets.

TRISs

TRISs will not be in the retirement phase from 1 July 2017, unless the individual has satisfied a further condition or release (see following discussion). This means that a TRIS that has been established because the member has reached preservation age will be considered in the accumulation phase, and will not be subject to the transfer balance cap and they will not be entitled to the tax exemption on the earnings generated by the assets supporting them.

Anyone paying a TRIS in the accumulation phase can continue to pay it beyond 1 July. However, the pension will not be as tax effective for the fund as it previously was. There is no change in the taxation treatment of payments received by superannuation members.

Unlike the transfer balance cap, a fund is not required to commute the TRIS in accumulation phase to be eligible to apply the relief. This is a key difference.

TRISs in retirement phase

As stated in the preceding discussion, a TRIS will not be in the retirement phase unless the member satisfies a further condition of release. In the event that a member satisfies any of the following nil-cashing-restriction conditions of release, the TRIS will convert from the accumulation phase to the retirement phase. The conditions are:

- retirement
- terminal illness
- permanent incapacity
- turning age 65.

In each of these events, with the exclusion of turning 65, the TRIS remains in the accumulation phase until the member notifies the trustee of the fund. In the instance of an SMSF, this notification should be documented, given the closely held relationship between the members and trustees. Turning 65 automatically converts the TRIS to retirement phase.

TRIS relief versus transfer balance cap relief

The importance of the changes introduced to allow a TRIS to move from accumulation phase to retirement phase are relevant when contemplating the use of CGT relief.

CGT relief is only applicable to a TRIS in the event that it is losing its tax exemption. That is, remaining in accumulation phase. However, a TRIS that is in the retirement phase prior to 1 July 2017 will be treated the same as an ABP and, as such, will be entitled to the relief if it has to be partially commutated to comply with the transfer balance cap.

Example

TRIS accumulation versus TRIS retirement

Bobby, aged 62, is in receipt of a TRIS. At 30 June, the value of that TRIS was $1.4 million. Bobby has passed preservation age, but has not retired. Therefore, Bobby's TRIS is in accumulation phase and he is entitled to claim CGT relief.

What if Bobby had retired in 2017?

If Bobby had retired, and had notified his trustee, then his TRIS would be in the retirement phase. In this instance, Bobby would not be entitled to CGT relief because he does not have a transfer balance cap issue and he does not have a TRIS in accumulation phase.

Of course, Bobby's SMSF will still be entitled to exempt current pension income because the TRIS is below the transfer balance cap.

What if Bobby's TRIS was $1.8 million?

If Bobby retired prior to 1 July 2017, then his TRIS would be in the retirement phase, and his SMSF would be entitled to apply CGT relief because of his requirement to comply with the transfer balance cap — in this instance, commuting $200,000.

Common rules apply to all

In addition to the relief only being applicable to those affected at 1 July 2017 by the introduction of the transfer balance cap or those in receipt of a TRIS in accumulation phase, there are a couple of key requirements that must be met by all funds that make an election to apply the relief. These requirements are linked to the "pre-commencement period".

Pre-commencement period

The pre-commencement period is the period from when the Treasury Laws Amendment (Fair and Sustainable Superannuation) Bill 2016 was first tabled into the Parliament until the reform commenced. This period was 9 November 2016 until immediately prior to 1 July 2017 (30 June).

First, the fund must be a complying superannuation fund throughout the pre-commencement period. Second, any asset to which the transitional CGT relief is to be applied must have been held throughout the pre-commencement period.

The relief is provided on an asset-by-asset basis so a fund can elect to which, if any, assets to apply the relief.

Did you know?

How are assets treated if they are sold during the pre-commencement period?

The transitional CGT relief is only applicable for assets held throughout the pre-commencement period, meaning the relief is available to uplift the cost base of assets that will continue to be held by the fund, but will be supporting a pension to a lesser degree.

Assets disposed of during the pre-commencement period are not entitled to the transitional CGT relief because the asset would be exempt under the existing provisions.

SMSF (and small APRA) integrity measures

One of the important considerations for applying the transitional CGT relief is that for SMSFs where one member is in retirement phase and has a total superannuation balance greater than $1.6 million, the SMSF cannot segregate its pension assets from 1 July 2017. This will be an ongoing taxation compliance requirement measured annually.

The importance of this measure with regard to the transitional CGT relief is that where a fund had segregated assets prior to 1 July 2017, and a member is affected by the transfer balance cap, resulting in them having to transfer value to accumulation phase, then they will not be able to segregate the assets post-1 July.

Therefore, the relief provides these funds with an opportunity to uplift the cost base of all assets so that once they move into a hybrid environment of both pension and accumulation, they will do so with a refreshed higher cost base.

It should be noted that the SMSF integrity measure is linked to an individual's total superannuation balance, so there may need to be action within the SMSF, even if the member does not have $1.6 million pensions in the SMSF. This is because the total superannuation balance considers all superannuation interests not just what is in the SMSF.

Segregated pension assets

A fund can select assets to support the payment of a pension, and those assets are entitled to an exemption on the income earned. For a fund with pension and accumulation interests, the value of segregated pension assets cannot exceed the pension balance. For CGT purposes, any gains or losses attributable to segregated pension assets are ignored for taxation purposes. Funds that only pay a pension are considered "segregated".

Using the segregated method

A fund that was using the segregated method at the start of the pre-commencement period is entitled to the transitional CGT relief if the asset ceased being a segregated pension asset at the cessation time, but continued to be an asset of the fund throughout the period.

For an SMSF, an asset ceases being a segregated pension asset if as a result of a pension being commuted to comply with the transfer balance cap it is transferred to accumulation phase and subsequently ceases to solely support pension interests at that time.

Alternatively, it ceases being a segregated pension asset if the fund starts to use the proportionate method. Historically, a fund that elected to use the segregated method made a conscious decision about which assets would support the pension. However, in more recent times the ATO has adopted a process by which a fund was deemed to apply the segregated method if 100% of the assets supported the pension, thus removing the decision process.

In LCR 2016/8, the ATO identifies as an example, that CGT relief is available where a fund moves an asset from a segregated pension asset to a segregated non-current asset. A segregated non-current asset is a legislatively defined term that refers to assets again where a conscious decision has been made to identify the asset as an accumulation asset. This process is rare in the SMSF environment.

Cessation time

The cessation time can be any time during the pre-commencement period if the fund was using the segregated method.

Deemed transaction

At the cessation time, the fund will reset the cost base via a deemed sale at the market value and immediately undertake a deemed purchase at the same market value.

As the asset was a segregated pension asset, the capital gain will be disregarded for taxation purposes.

There are many things to be considered before either electing to use the transitional CGT relief or ignoring it.

Case study 1

Segregated assets and applying the relief

At the start of the pre-commencement period, The Jones SMSF has the following superannuation structure.

- Member 1 — ABP $2,000,000 (cost base $1,000,000)
- Member 2 — accumulation $500,000 (cost base $300,000).

Member 1 will need to roll back $400,000 from the ABP to the accumulation phase so that the pension value on 1 July 2017 is no more than $1.6 million.

Segregated assets

On the assumption that the fund has segregated pension assets at the start of the pre-commencement period, the trustees have the following options available.

Option 1: do nothing

If the fund does nothing (other than internally roll $400,000 back to accumulation) then at 1 July 2017, the fund will resort to an unsegregated fund with a pension liability of $1.6 million and a superannuation liability of $2.5 million.

Based on the future need to use the proportionate method, if the fund sells an asset post-1 July 2017, then it will be able to apply the CGT discount (asset held longer than 12 months), and 64% of the discounted gain will be exempt current pension income (on the basis that $1,600,000/$2,500,000 = 64%).

Option 2: move $400,000 from segregated pension pool to segregated accumulation pool

Option 2 for the fund is that it could make the election to move $400,000 from the segregated pension pool to an accumulation pool. Based on the assets held, the fund may choose a specific asset or assets. The fund may even transfer greater than $400,000 from the member's pension on the assumption that certain assets are currently valued greater than $400,000.

In effect, member 1 is commuting their existing pension to the value of $400,000. That is, they are consciously making a decision to exchange the pension for a lump sum that is either taken out of superannuation altogether or rolled back to accumulation.

If one assumes that based on the assets held, the fund rolls exactly $400,000 from pension to accumulation on 31 March 2017, what effectively happens is:

› those selected assets are deemed to be sold and repurchased on 31 March 2017

› the CGT is ignored as the assets are currently segregated pension assets, and

› the cost base is reset to $400,000 and the 12-month discount period is reset.

This option is acceptable, however, it must be recognised that by selecting 31 March, the trustees are commuting the pension during the financial year. Thus, the fund will be required to pay tax on the earnings attributable to the $400,000 for the remainder of the year.

Option 3: move all pension assets from segregated pension environment to a pooled (proportionate) environment

Option 3 for the fund, as a result of the SMSF integrity measures, would be to make an election to move all of the $2 million pension assets from the segregated pension environment to a pooled (proportionate) environment. This can occur at any time throughout the pre-commencement period. However, given it also incorporates a need to commute the pension, consideration should be given to the timing being closer to, if not, 30 June.

> If the fund takes this approach, all $2 million would be realised on the cessation date, and the assets would reset their cost base (and date) effectively uplifting from $1 million to $2 million. As all the assets are segregated, the capital gains are ignored. An obvious disadvantage of this approach is that if any of the segregated assets are currently in a loss position, those losses will also be ignored.
>
> If the fund assets were unsegregated at the start of the pre-commencement period, then there are different choices to be made.

Tax avoidance

To apply the transitional CGT relief, there must be a need. Therefore, if one has a fund that is not affected by this superannuation reform because their pension and fund balance is too low, or is not a TRIS that will continue to be in the accumulation phase, then the transitional CGT relief is not available. Similarly, a fund cannot enter into an arrangement to avail itself of the transitional CGT relief or for the purpose of abusing the relief provisions.

If a fund does no more than is necessary to comply with the reform, that is, it commutes an existing ABP, then it will not be subjected to potential tax avoidance measures. If, however, a fund enters into a transaction for the purposes of enabling the fund to make the required election, and the purpose is to obtain the tax benefit, then the fund may come under scrutiny.

Schemes that will come into scrutiny will include, but are not limited to:

› funds that start a pension immediately prior to the pre-commencement period, apply the relief and then cease the pension

› funds that previously did not segregate assets which elect that assets are segregated at the commencement of the pre-commencement period, and subsequently revert to proportionate after the deemed sale.

All transactions should take into account whether the fund is doing any more than necessary.

Unsegregated pooled assets

For a fund with pension and accumulation interests, if no assets are specifically identified as supporting the pension, the fund uses the proportionate method to calculate the taxation position, and is required to obtain an actuarial certificate to determine the annual tax exemption. For CGT purposes, any gains or losses attributable to unsegregated pension assets are taxed proportionately.

Using the proportionate method

A fund that was using the proportionate method at the start of the pre-commencement period is entitled to the transitional CGT relief, so long as the assets held did not become segregated pension or accumulation assets, but continued to be assets of the fund throughout the period.

Cessation time

The cessation time if the fund is using the proportionate method is 30 June 2017.

Deemed transaction

At 30 June, the fund will reset the cost base via a deemed sale at the market value and immediately undertake a deemed purchase at the same market value.

As the asset was not a segregated pension asset, the capital gain will be apportioned between taxable and tax exempt.

CGT deferral

As a taxation calculation is required and a tax liability is raised, under the proportionate method, a fund will have the option to defer the capital gain until the asset is physically sold. This election will be made via the 2016/17 taxation return.

Case study 2

Applying the relief – proportionate method

Let us revisit the Jones SMSF.

- Member 1 — ABP $2,000,000 (cost base $1,000,000)
- Member 2 — Accumulation $500,000 (cost base $300,000).

Member 1 will need to roll back $400,000 from the ABP to the accumulation phase so that the pension value on 1 July 2017 is no more than $1.6 million.

Unsegregated assets

As the fund assets were unsegregated throughout the pre-commencement period, then the proportionate method must be used, and the transaction date for the sale and repurchase is 30 June 2017. With the proportionate method, the fund must make an additional election whether to pay the tax liability attributable to the gain in 2016/17, or defer it.

The fund has $2.5 million total assets with $2 million currently representing pension assets, and the cost base of the assets is $1.3 million. Being aware that the fund has to roll back $400,000 at 30 June 2017, it can avail itself of the relief, but it must consider at what level to apply the relief. As stated, certain anti-avoidance measures have been incorporated in the legislation so if the fund is using the proportionate method, the ATO may question to what extend the relief needs to be applied.

Be that as it may, the fund could apply the relief to all of the assets. However, given there will be a tax liability raised, the question is whether under the proportionate method this is the right approach.

Option 1 is again to take no action and the original cost base will carry on, with the only activity being the pension commutation.

Option 2 allows the fund to uplift the cost base on all, or any, of the assets at 30 June 2017.

At 30 June 2017, the SMSF has a current pension liability of $2 million and a superannuation liability of $2.5 million. The exempt current pension income (ECPI) deduction on this date is 80% (an estimation for illustrative purposes).

If the fund applies the relief to the rolled-back amount it has selected of $400,000, and one assumes that the gain is $200,000, then the discounted gain is $133,333 and the ECPI deduction is $106,666 (80%).

The fund has an assessable gain of $26,667, resulting in a tax liability of $4,000. The fund can either pay the tax in 2016/17 or make a further election to defer the gain to when the asset is eventually sold. No further discounts will apply to the deferred gain in the future, although any accumulated losses the fund has at that time may be used to offset the gain.

Making an election

Part of the process of applying the transitional CGT relief is making an election for the relief to apply. This election must be made on or before the lodgement date of a fund's 2016/17 tax return, and will form part of the return. The Commissioner of Taxation recently provided an extension of time to lodge the 2016/17 Income Tax and Regulatory return for all SMSFs. In part, this extension was provided in recognition of the additional work required to complete 2016/17 lodgement including the application of the CGT relief.

The election, once made, is irrevocable, so a fund must consider all elements before either electing to apply or not to apply the relief because once that choice is made, it cannot be reversed.

Considerations

When contemplating the use of CGT relief there are some issues that need to be taken into consideration by the fund trustees. These include whether a fund's pension position will change shortly after 1 July 2017.

Example

Will someone currently with a TRIS in accumulation phase satisfy one of the noted conditions of release in the near future and, therefore, move into the retirement phase? If that is the case then the fund will move back into a tax-exempt environment, subject to the transfer balance cap, and so relief may not be necessary.

Additionally, a fund will need to review whether it has intentions of selling any assets within 12 months of resetting the cost base, as such a sale will not be entitled to CGT discount.

Conclusion

The CGT relief is a transitional measure that provides taxation relief to those who were in a tax-exempt environment prior to 1 July 2017, but will have that tax exemption removed or reduced after that date.

There are a number of considerations that must be made when applying the relief, such as the method used for calculating the tax exemption, but also which assets will it apply to and what future events may be impacted by the decision.

Funds should use the extension provided by the ATO to determine whether CGT relief is applicable and what action, if any, will be taken as part of the 2016/17 lodgement cycle.

Regardless of whether a fund utilises the transitional CGT relief, the SMSF integrity measures must be complied with from 1 July 2017. Thus, all funds that previously held segregated assets need to review whether they are entitled to continue to do so.

References

Australian Taxation Office 2018, Law Companion Ruling LCR 2016/8 *Superannuation reform: transitional CGT relief for complying superannuation funds and pooled superannuation trusts*, 19 February, Australian Taxation Office for the Commonwealth of Australia, Canberra, viewed 13 March 2018 from <https://www.ato.gov.au/law/view/document?docid=COG/LCR20168/NAT/ATO/00001&PiT=20180219000001#LawTimeLine>.

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