Pre Budget Planning Update

What should SMSF members and trustees be thinking about in the lead up to the budget?

The budget is always a tricky time – should we speculate about what might happen and try to pre-empt it? Or should we plan around the law we know about rather than what might happen in a few weeks' time on the basis that trying to predict the unpredictable often means we jump at shadows?

I've traditionally been in the latter camp. Even when governments do make big announcements on Budget night, will they necessarily be legislated immediately? In fact, will they be legislated at all? Is it worth potentially compromising long term superannuation plans just on the off chance unfavourable changes will be made as part of the federal budget?

This time my view is different. In the current environment there are several things I believe it would be worth acting on now.

I've rashly put my thoughts down in this article and like everyone else, I will be watching the Treasurer's address on 3 May to see if any were worth taking!

Thinking about transition to retirement? Start now.

Some day, transition to retirement pensions are likely to be reigned in – particularly for those who start pensions without any change to their working arrangements.

Remember why transition to retirement pensions have that name? They were introduced to ease the transition from full time work to retirement. They do it by allowing superannuation pensions to start before *full* retirement and fill the income gap created when one winds back to part time or consulting work. However, they were legislated by simply allowing anyone over their "preservation age" to start one, regardless of whether or not anything had actually changed in their work life. The outcome was an excellent tax planning strategy – many people over 55 (the preservation age until it increased to 56 this year) made no changes to their work arrangements, started a pension and used the extra income to increase their salary sacrifice superannuation contributions. Because super funds don't pay income tax on the income they earn on pension accounts, the net effect is generally a tax saving. That's despite the fact that often the arrangement is a complete round robin of cash – the individual withdraws pension payments from super but quite possibly increases their contributions into super by the same amount.

One day I expect transition to retirement pensions to either be pushed out to a later age or linked in some way to a change in personal circumstances. The gradual increase in preservation age has already started to push out the earliest starting date for many looking to start a transition to retirement pension.

But ... this budget is a possible time where the eligibility rules might be reigned in. It would be politically easier than many other changes to super, it is the kind of change that could be introduced with effect from budget night without major complexity in the law. Its saving grace might be that it is unlikely to be a major revenue winner.

So I would consider starting transition to retirement pensions now (before budget night) if it's attractive to do so. Given the new options for minimising the tax on payments taken from a pension (see below), a transition to retirement pension is attractive for almost everyone with a material super balance who is eligible to have one (they must have turned 55 on or before 30 June 2015) with the possible exception of those:

- in SMSFs that can't support the cash flow required to pay the pension, even if it uses contribution income;
- whose fund is earning little or no taxable investment income at the moment; or
- who are already absolutely maximising all their contributions.

Even these people should do the numbers before ruling it out!

Does a payment need to be taken before budget night?

The principle that a pension can start some time before the first payment is made has been well established. For that reason, I do not believe it is essential to *take a payment* before budget night.

And what if nothing happens?

Remember that in an SMSF, pensions can be switched off at any time. It will be necessary to pay them "up to date" which will require some payment between commencement and (say) May / June 2016 but this is a pro-rated amount. So if the pension is in place for 2 months, the payment required would be roughly 2/12 x 4% of the balance at commencement.

Have a transition to retirement pension (or about to start one) and want to use the lump sum strategy? Do it now.

There has been some publicity (but nowhere near enough in my opinion) about the ATO's change in view on a key aspect of transition to retirement pensions.

The ATO now considers that <u>any individual receiving a transition to retirement pension can elect to have some or all of the payments they receive from that pension taxed as lump sums</u>. There is a host of really important documentation and legal subtleties here so the strategy should be put in place with help from an SMSF expert but the implications are critical.

Most people associate tax free super as something that happens from 60. This change in view means that it can happen earlier – in fact as soon as the pension starts.

There is a limit on how much can be taken out tax free over one's lifetime but it is high – just under $200,000. Hence this pretty much rules out one of the only downsides of starting a transition to retirement pension – the fact that you have to draw out pension payments and you might pay high rates of tax on them (worst case, 30% if you are paying income tax at the top marginal rate).

Because the ATO initially only expressed this view via a Private Binding Ruling (which is a tax ruling that only applies to the taxpayer to whom it is issued), we've generally suggested that clients obtain their own private ruling before following this strategy. But the Commissioner has effectively reiterated this position in a number of forums and via the ATO's own web content so it would seem fairly clear.

Many describe this generous treatment as a loophole. If so, it's a loophole that's been around since 2007, all that has changed is that the ATO has only recently accepted it exists. But of course budget night is certainly an opportunity to close it.

For that reason, individuals looking to take advantage of this strategy who haven't yet received a response to their private ruling request or who have decided not to obtain one should consider taking a payment before budget night (and ensuring the requisite documentation is in place).

Note that this is completely different to taking a pension payment to "prove" that a pension is in place. As mentioned earlier, I don't believe that is necessary. The purpose of this payment would be to achieve a particular tax treatment on the payment itself.

Make large contributions?

I fully expect that we may see reductions in the non-concessional contributions cap in the future – perhaps winding back the ability to trigger the "bring forward" rules that allow three years' worth of contributions at once.

Those who are making large contributions this year might choose to do so ***before*** budget night. Remember that it's entirely legal to borrow money to make a personal super contribution, it's just that the interest is not tax deductible and obviously security from personal assets would be required. Long term borrowing in this way is unlikely to be tax effective but it would allow a contribution to be made quickly if the personal cash is not yet available.

Those who were planning to make large contributions *next year* are in a harder place – bringing those forward will generally compromise longer term plans. My instinct is to leave those plans in place and accept the risk that the bring forward rules may change on budget night.

Thinking about withdrawing large amounts of taxable money and making non-concessional contributions?

Again, think about doing this ***before*** budget night. And remember, cash need not be a constraint.

Remember:

- clients that have unpreserved money can take in-specie benefit payments. But take care! If you're looking at an in-specie recontribution of the withdrawn asset, make sure the asset transferred out, can actually be transferred back in (eg, listed securities, shares / units in unlisted controlled entities, widely held trusts etc would all be acceptable); and
- the contribution could occur *first* – providing cash to the fund, followed by the benefit payment. Just make sure your client has sufficient unpreserved money to make the benefit payment!

What I'm not overly concerned about

I don't expect changes to:

- limited recourse borrowing arrangements for SMSFs – there have been so many opportunities to change these that have been ignored. The ATO's recent guidance on ensuring loan conditions are always commercial has indirectly tightened the major weakness many felt existed. Overall, I feel the risk is lower this year than it has been for many years;
- concessional contribution limits – while these may well come down, I doubt that the change would be effective immediately on budget night;
- the tax treatment of superannuation pensions after 60 – this may make a lot of sense in the longer term but it would be politically difficult to achieve right now;
- tax treatment of funds paying pensions – even if we see this, I expect it's unlikely to be introduced immediately on budget night and there are no obvious pre-emptive actions one could take to mitigate the impact without major disruption to the fund (eg selling all its assets to realise capital gains pre budget).

So here's hoping we have a very uneventful 3 May on the superannuation front and that all the actions suggested above have been unnecessary.