Units trusts and cost base resets under the TBC

by Phil Broderick, CTA, Sladen Legal

The cost base reset under the new transfer balance cap can be problematic for super funds that hold units in a unit trust.

Introduction

The new superannuation laws have recently been passed by the federal government.[1] The new laws include the introduction of the transfer balance cap (TBC). The TBC limits the amount a member can transfer into a pension account in a super fund. The initial cap will be $1.6m.

As a result, from 1 July 2017, members who have pension account(s) in excess of $1.6m will have to commute their pension(s) back to a balance of $1.6m. This will result in a reduction of the amount of assets that affected super funds can have in "pension phase" (ie where earnings and capital gains are tax-free).

In order to reduce the retrospective effect of these measures, affected super funds can elect to reset the cost base of capital assets to equal market value on 30 June 2017.

While the cost base reset provides welcome relief for assets held directly by super funds, as outlined below, the operation of the cost base reset, where the super fund holds units in a private unit trust (or shares in a private company), does not always provide full relief from CGT.

In this article, the cost base reset rules are examined first. Then the problems with units are considered. Finally, options available for such units are discussed.

Although the measures apply to all super funds, this article only examines the reset from the perspective of a self-managed superannuation fund (SMSF).

Which super funds are eligible for the cost base reset?

In order to be eligible for the reset, the following pre-conditions must be met.

Precondition 1 – the fund must be in pension phase

The reset applies to any super fund that is in pension phase (either in part or in full).[2] This is regardless of whether any members will exceed their TBC at 1 July 2017. This will include funds that have transition to retirement income streams that will cease to qualify for pension phase at 1 July 2017. The reset does not apply to super funds that are solely in accumulation phase.

Precondition 2 – assets must be held prior to 9 November 2016

The reset only applies to assets held prior to 9 November 2016.[3] Any assets acquired after that date (even if before 1 July 2017) will not be eligible for the cost base reset.

Precondition 3 – fund trustee must make an election to choose the reset

The cost base rest is not automatic. An SMSF trustee must elect to choose the reset for each asset of the SMSF.[4] The election must be in approved form (yet to be determined). The election is irrevocable and must be made before the SMSF trustee is required to lodge the SMSF's tax return for the 2016-17 year.[5]

How the cost base reset works

Application of the reset

The reset works by deeming an elected asset to be sold on 30 June 2017 for its market value and repurchased at that price.[6] This effectively resets the cost base of the asset to market value on 30 June 2017. Consequently, only gains from 1 July 2017 onwards will be taxed.

The application of the reset differs depending on whether the SMSF is using the segregated or proportionate method.

SMSFs using the segregated method

Where any SMSF has at least one member who has a total superannuation balance that exceeds $1.6m and that member is in receipt of a super pension, then, from 1 July 2017, that SMSF can no longer use the segregated method for calculating their exempt current pension income (ie pension phase).[7] Self-managed superannuation funds which don't have any such members can continue to use the segregated method. Therefore, at 1 July 2017, SMSFs with at least one member who has a pension and more than $1.6m of benefits must use the proportionate method.

For SMSFs using the segregated method prior to 1 July 2017, the cost base reset works by resetting the cost base to market value for each elected asset at 30 June 2017. Therefore, each SMSF trustee using the segregated method must review each segregated asset acquired on or before 9 November 2016 that is still held at 30 June 2017, and elect whether to choose the cost base reset at 30 June 2017. An SMSF trustee could elect that either all assets be reset, no assets be reset or some but not all assets be reset.

As a general rule, it is likely that many SMSF trustees will elect that all of the SMSF assets have their cost bases reset. However, situations where the SMSF trustee would not elect a cost base reset include:

- where the asset's market value is less than its cost base (ie it would make a capital loss if sold); and
- where the asset is likely to be sold before 30 June 2018 and the one-third CGT discount is more valuable than the cost base reset.

An SMSF using the segregated method can elect to move to the proportionate method prior to 30 June 2017. If that occurs, the cost base reset occurs on that date. An SMSF may do this to start the 12-month holding period prior to 30 June 2017.

SMSFs using the proportionate method

Self-managed superannuation funds using the proportionate method are also eligible to reset the cost base of their assets at 30 June 2017. Again, this can be elected for all of the SMSF's assets or just for selected assets.

However, the big difference as to how the reset applies to the proportionate method as compared to the segregated method is that the proportionate method cost base reset will trigger a capital gain on assets not fully in pension phase and therefore potentially trigger a taxable capital gain. Where a taxable capital gain is triggered, the government has given SMSFs two options for dealing with this.

Option 1 – pay tax in the 2016-17 year

Under option 1, the SMSF will pay tax on the assets in the 2016-17 year. For example, say an SMSF has $3m in assets, and $2m (2/3) is in pension phase. The cost base of the assets is $600k and all assets have been held for 12 months or more. The SMSF trustee elects that all of the assets will receive the reset. On 30 June 2017, the SMSF is deemed to make a capital gain of $800k (ie 1/3 of the value of the assets ($1m) less 1/3 of the cost base ($200k)). The SMSF pays $80k of tax for the 2016-17 year (ie 10% of the capital gain of $800k) and holds assets with a cost base of $3m.

Option 2 – defer notional tax on assets until they are sold

Under option 2, the SMSF does not pay tax on the gain on the asset until the asset is sold.[8] The capital gain cannot be offset against capital losses. The previously announced 10-year window to dispose of the asset has been dropped. Therefore, the deferral will be maintained until the asset is sold.

For example, say an SMSF has $3m in assets and $2m (2/3) is in pension phase. The SMSF elects to apply the reset to a real estate asset worth $2.1m. The cost base of the real estate asset is $600k. The SMSF trustee elects that all of the assets will receive the reset. The SMSF makes a notional capital gain of $500k on the real estate (ie 1/3 of $2.1m ($700k) less 1/3 of $600k cost base ($200k)). If the SMSF sells the real estate five years later for $4.1m when it is 50% in pension phase, it makes a taxable capital gain of $1m ($4.1m less $2.1m multiplied by 50% in accumulation phase). In addition, it must bring to account the notional capital gain that it triggered on 30 June 2017 of $500k. Therefore, it pays tax of $150k (ie the $1.5m total capital gain multiplied by 10%).

Problem with the cost base reset for units

For SMSFs with units in private unit trusts (and shares in private companies), the cost base reset also applies. However, the cost base reset only applies to the units (shares) held by the SMSF and not the underlying assets held by the unit trust (or company). This will be problematic if the underlying asset is sold rather than the units (shares). This is because the full capital gain made on the disposal of the unit trust's assets will flow through to the super fund and such gains will not be reduced by the cost base reset of the units.

For example, an SMSF holds 100% of the units in a unit trust. The units have a cost base of $500k and a market value of $2.5m. The unit trust has real estate with a cost base of $500k and a market value of $2.5m. At 1 July 2017, the SMSF receives a cost base reset for its units so that their cost base is now worth $2.5m. The unit trust sells the property two years later for $3.5m. The unit trust makes a capital gain of $3m ($3.5m less $500k). The SMSF is 50% in pension phase so it pays CGT of $150k ($3m divided by 50% (in accumulation phase) multiplied by 10% (the SMSF CGT rate)). The unit trust is wound up three years later and the SMSF receives a capital loss of $2.5m.

In this example, the SMSF pays the CGT on the disposal of the unit trust property and does not achieve any immediate advantage from the reset of the cost base of the units. The cost base reset does eventually result in a capital loss when the unit trust is wound up. However, those capital losses may not be able to be recouped from future capital gains for a number of years (or may not be recouped at all).

Options for SMSFs with units in unit trusts

Self-managed superannuation funds with units in private unit trusts (or shares in private companies) should consider whether it is likely that some or all of the unit trust's CGT assets will be disposed of while the SMSF holds units in the unit trust. For example, some SMSFs may consider that the unit trust will not dispose of any assets and that instead the SMSF will dispose of the units (by way of sale, redemption or the payment of member/death benefits). For such SMSFs, the cost base reset will be effective.

For SMSFs that consider it likely that the unit trust will dispose of some or all of its assets while the SMSF holds units, there are a number of options that could be considered, including:

- winding up the unit trust prior to 1 July 2017 (however, any duty consequences should be considered);[9]
- transferring the unit trust assets out of the unit trust (eg by way of sale or by way of transfer of the assets from the unit trust to the SMSF — however, any duty consequences should be considered);[9] and
- winding up the unit trust in the same year that the asset is sold (however, this may not be feasible if the unit trust has other assets).

Conclusion

The cost base reset is an important concession that reduces the retrospective aspect of the TBC measure. However, the cost base reset does not always work perfectly for units held by an SMSF. As outlined above, certain options are available for SMSFs both pre- and post-30 June 2017 which may allow SMSFs to more effectively utilise the reset.

Phil Broderick, CTA
Principal
Sladen Legal

References

1 *Treasury Laws Amendment (Fair and Sustainable Superannuation) Act 2016* (Cth).
2 Ss 294-110(1)(a) and 294-115(1)(b) of the *Income Tax (Transitional Provisions) Act 1997* (Cth) (ITTPA).
3 Ss 294-110(1)(a) and 294-115(1)(a) ITTPA.
4 Ss 294-110(1)(e) and 294-115(1)(e) ITTPA.
5 Ss 294-110(2) and 294-115(2) ITTPA.
6 Ss 294-110(3) and 294-115(3) ITTPA.
7 S 295-387 ITAA97.
8 S 294-120 ITTPA.
9 The prohibition against a super fund acquiring assets from a related party under s 66 of the *Superannuation Industry (Supervision) Act 1993* (Cth) must also be considered if the unit trust trustee is a related party and the asset is not an exempted asset. Exempted assets include business real property and listed shares.