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The ultimate guide to understanding ECPI and segregation

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It all depends on ECPI…

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How a fund claims ECPI impacts capital gains and losses, expense deductibility and tax losses and depends on the type of fund.

Today we are going to consider the key fund types for ECPI:

1. A fund which always has a non-retirement phase account during the year
2. A fund which is solely in retirement phase over the entire year
3. A fund which has periods where it is solely in retirement phase but at other times also has a non-retirement phase account
4. A fund with assets elected to be segregated

What is ECPI?

ECPI = exempt current pension income

- Reduces a fund's assessable income
- Eligible if have a retirement phase income stream and minimum pension standards met
- ECPI applies to assessable income including net capital gains, excluding non-arm's length income and assessable contributions
- ECPI is calculated annually

Claimed in the SMSF annual return at

- Section A Item 10
- Section B Item 11Y

A fund which always has a non-retirement phase account

Good Life Super Fund

Good Life Super Fund

Jack & Marilyn are completing their 2017-18 SMSF annual return

- Jack had opening ABP balance $839,420 and made payment of $33,600 on 15 July
- Marilyn had opening accumulation balance of $404,225 and received concessional contributions of $5,000 on 1 Sept and 1 Dec, and $7,500 on 1 Mar and 1 Jun
- $40,000 capital gain, $25,455 other assessable income, $1,500 in expenses incurred

This is a fund which always has a non-retirement phase account during the income year.

SMSF which always has a non-retirement phase account

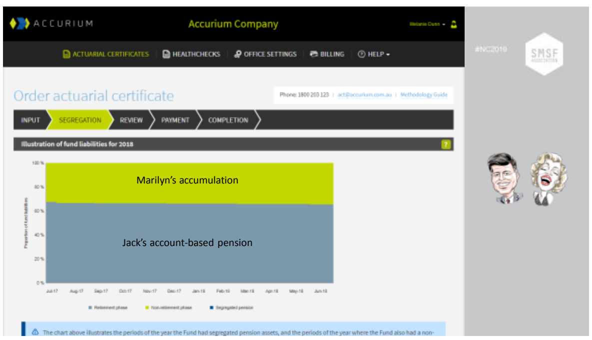
Claim ECPI using the proportionate method in Section 295.390 of ITAA 1997

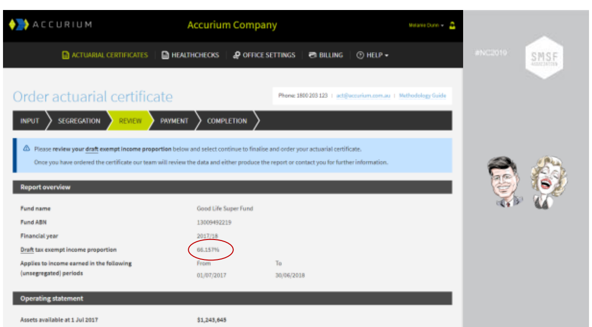
- Applies when a fund is not solely supporting retirement phase accounts
- Trustee requires an actuarial certificate if want to claim ECPI (optional)
- Actuarial certificate applies for a full income year and states the proportion of income earned in that year that is exempt income

ECPI = exempt income proportion x assessable income

- Assessable income excludes non-arm's length income and assessable contributions and includes net capital gains

Proportionate method is the most commonly used until a fund is solely in retirement phase





Good Life Super Fund capital gains

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Fund had $40,000 net capital gain due to sale of fund assets in 2017-18

For a fund using the proportionate method the timing of when gains or losses are received will not impact how they are taxed

- A net capital loss is not included in assessable income and is carried forward to offset future capital gains (cannot be offset against income)
- A net capital gain is included in assessable income and will have the actuarial exempt income proportion apply

Good Life Super Fund calculating ECPI

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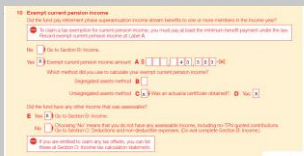
- Actuarial exempt income proportion = 66.157%
- $25,455 in assessable income excluding assessable contributions in 2017-18
- $40,000 net capital gain due to sale of fund assets

Assessable income including net capital gain = 40,000 + 25,455 = $65,455

ECPI = 0.66157 x 65,455 = $43,303.06



Maximising proportionate method ECPI

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$$\text{Exempt income proportion} = \frac{\text{average value of retirement phase liabilities}}{\text{average value of superannuation liabilities}}$$

- This uses a daily weighted average so *when* a transaction occurs is important

To maximise exempt income we want more in retirement phase on average:

- Pension payments and lump sums later in a year
- Pension commencements earlier in a year

Less in non-retirement phase on average:

- Accumulation withdrawals earlier in a year
- Contributions later in a year

Good Life Super Fund calculating ECPI

If instead had made contributions and pension payments on 15 June 2018…
Actuarial exempt income proportion = 67.408%

- Previously was 66.157%

Not much in this case but…

- Biggest improvement will come with timing of one off material transactions such as pension commencements, lumpy withdrawals or rollovers
- Maximise exempt income proportion to maximise exempt income on capital gains

Deductibility of expenses

Expenses that are ordinarily deductible can generally be claimed as a tax deduction to the extent they were incurred in producing assessable income

- Section 8-1 of ITAA 1997 unless a specific deduction such as Section 25-5 applies
- TR 93/17 also sets out general principles
- Expenses that are of a capital nature cannot be claimed as a deduction under Section 8.1

Some expenses are fully deductible including those for managing the fund's tax affairs

- ✓ Actuarial certificate fees
- ✓ Supervisory levy
- ✓ Costs relating to preparation and lodgment of the annual return

Deductibility of expenses

Distinct and severable expenses

- An expense directly incurred in producing assessable income is entirely deductible
- An expense directly incurred in producing exempt income is not deductible at all

Expenses which must be apportioned on a fair and reasonable basis

- An expense incurred in producing both assessable and exempt income is deductible to extend incurred in producing assessable income

Common methods where have a non-retirement phase account over the entire year:

- Actuarial method of (1 – exempt income proportion)
- TR 93/17 method of assessable income / total income

Good Life Super Fund expenses

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$5,000 in general administrative expenses, $1,000 in deductible expenses

- Expenses fully deductible: $1,000
- Expenses which must be apportioned: $5,000

Jack and Marilyn have been using the actuarial method to claim a deduction on expenses which must be apportioned:

- Expense deductibility = 1 - exempt income proportion = 1 – 0.66157 = 33.843%
- Deductions = 1,000 + 5,000 x 0.33843 = $2,692.15
- Non-deductible expenses = $3,307.85

Total deductions = $2,692.15 Total non-deductible expenses = $3,307.85

Utilising tax losses

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A tax loss occurs when total deductions claimed for a year exceed total assessable income

- A tax loss is carried forward to be claimed as a tax loss deduction in the following year
- Section C Item 12 O in the SMSF annual return shows a fund's taxable income or loss

In order to claim a tax loss deduction at Section C Item 12 M1 of the annual return there is a process that must be followed:

1. Calculate net ECPI – this is the year's ECPI amount less any expenses that were incurred in deriving exempt income
2. Reduce the tax loss carried forward by the net ECPI amount
3. Any remaining amount can be claimed as tax losses deducted to offset assessable income in the annual return

Good Life Super Fund utilise tax losses

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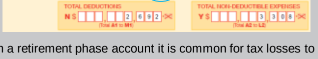
Carried forward tax loss of $1,500

1. Net ECPI = ECPI – non-deductible expenses = 43,303 - 3,308 = 39,995
2. Tax loss – net ECPI = max(1,500 – 39,995, 0) = 0
3. There is no remaining amount to claim in the annual return. All tax losses have been used up.



Tax losses deducted M1 $ 0

TOTAL DEDUCTIONS N $ 2,692 (Total A1 to M1)

TOTAL NON-DEDUCTIBLE EXPENSES Y $ 3,308 (Total A2 to L2)

For a fund with a retirement phase account it is common for tax losses to be used up by net ECPI resulting in no deduction in the annual return.

A fund that always has a non-retirement phase account during the year

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- Will use the proportionate method to claim ECPI
- A net capital gain will have the exempt income proportion apply
- A net capital loss can be carried forward
- General administrative expenses must be apportioned and claimed as a deduction to the extent were incurred on assets producing assessable income
- Tax losses carried forward must be offset by net ECPI before claiming as a deduction

A fund which is solely in retirement phase over the whole year

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JR Super Fund

JR Super Fund

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Consider that Joe had a ABP balance of $3.1m in the JR Super Fund prior to 1 July 2017
There were a few options for what Joe could have done with his excess $1.5m…

1. Withdraw it from super altogether
2. Keep it in super but roll it over to a new SMSF solely in accumulation
3. Keep it in super in the JR Super Fund as an accumulation interest

Under option 3 he would have a fund which always had a non-retirement phase interest

Let's consider the impact of option 1 and 2 and assume Joe re-structured his affairs so that the JR Super Fund is solely in retirement phase for the entire 2017-18 income year

- There remained only $1.6m in JR Super Fund in an ABP at 1 July 2017

A fund solely in retirement phase

Segregated pension assets are those assets solely supporting retirement phase liabilities

Claim ECPI using the segregated method in Section 295.385 of ITAA 1997

- Don't need an actuarial certificate
- Income on segregated pension assets is ECPI (100% exempt)
- Capital gains and losses are disregarded and not included in assessable income
- General expenses are not deductible as incurred on assets producing exempt income

This method is most commonly used once a fund is fully in retirement phase
Except if the fund has disregarded small fund assets it cannot use the segregated method

Disregarded small fund assets

New annual assessment each 30 June for how a fund must claim ECPI in the next year

- Also applies in first year of the SMSF

SMSF will have disregarded small fund assets for the next financial year if:

- At 30 June a member was in retirement phase and had over $1.6m total super balance
- In next financial year the SMSF has a member in retirement phase at any time

If have disregarded small fund assets the fund is not eligible to use the segregated method for tax purposes and must claim ECPI using the proportionate method.

- Actuarial certificate is required to claim ECPI

Capital gains and losses

A fund solely in retirement phase over entire income year

- *Without* DSFA: the fund is deemed to have segregated pension assets and will disregard gains and losses under Section 118.320 of ITAA 1997
- *With* DSFA: the fund must use the proportionate method but assets are solely producing exempt income and so gains and losses will be disregarded under Section 118.12

The timing of when capital gains or losses occur does not impact how they are taxed

- Gains and losses are disregarded and are not included in assessable income
- Do not use up carried forward capital losses

JR Super Fund

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Joe is now completing the tax return for JR Super Fund for 2017-18

- Joe is in retirement phase for the entire year and makes a minimum pension payment
- $80,000 in assessable income in 2017-18
- $20,000 net capital loss
- $6,500 in general administrative expenses, $300 in deductible expenses
- There is $2,000 in tax losses carried forward from last year

JR Super Fund is solely in retirement phase for 2017-18

- Segregated method to claim ECPI? Disregarded small fund assets?
- ... it depends on Joe's TSB at 30 June 2017

JR Super Fund: Joe has no other super

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If Joe withdrew $1.5m from super and had $1.6m in JR Super Fund at 30 June 2017

- TSB at 30 June 2017 of $1.6m with a retirement phase account
- JR Super Fund *does not have* DSFA
- Claim ECPI using the segregated method

Segregated method for ECPI:

- Disregard $20,000 capital loss
- ECPI = assessable income = $80,000
- No other assessable income, can skip Section B: Income in the annual return

JR Super Fund: Joe has no other super

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Other 2017-18 tax items:

- Deductible expenses = $300
- Non-deductible expenses = $6,500

- Net ECPI = 80,000 – 6,500 = $73,500
- Tax loss deduction = max(0, 2,000 – 73,500) = 0

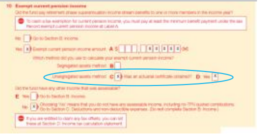
JR Super Fund: Joe has $1.5m in another SMSF

If Joe transferred $1.5m to a new SMSF which is solely in accumulation at 30 June 2017

- Joe has TSB at 30 June 2017 of $3.1m with a retirement phase account
- JR Super Fund *does have* DSFA
- Obtain an actuary's certificate and claim ECPI using the proportionate method

Proportionate method ECPI:

- Disregard $20,000 capital loss
- ECPI = assessable income x exempt proportion
  = 80,000 x 1.000 = 80,000
- Skip Section B: Income in the annual return



Maintaining segregation

Sometimes a fund that would otherwise be solely in retirement phase can have a momentary accumulation balance in the year:

- Commence a pension on 1 July with entire accumulation balance
- Receive a contribution and immediately commenced a pension
- Complete a partial commutation and immediately withdraw it from accumulation

An accumulation balance could mean a fund is not segregated at that time

ATO view: a matter of documentation as to whether fund requires an actuarial certificate

- If no income earned while in accumulation the segregation is maintained
- Example: a minute that says ABP commenced immediately with the entire contribution

A fund solely in retirement phase over an entire year

- Use the segregated method to claim ECPI if fund does not have DSFA for the year
- Use the proportionate method to claim ECPI if fund does have DSFA for the year
- A net capital gain will be disregarded (100% exempt)
- A net capital loss will be disregarded (cannot carry forward loss)
- General administrative expenses are not deductible
- Tax losses carried forward must be offset by net ECPI before claiming as a deduction

A fund with periods solely in retirement phase but at other times has a non-retirement phase account

Smith Super Fund

Smith Super Fund

Consider that when Jack left the Smith Super Fund after their separation, Jacqui O kept the fund running…

- Her $500,000 has grown to $1,480,450 at 1 July 2018
- She does not work and has not contributed to the fund for many years

Ori O has been thinking about super recently and suggests to Jacqui O that she

- commences an ABP when she meets her preservation age in March 2019, and
- puts more savings into super, starting with a NCC of $100,000 in June.

Deemed segregation

If assets are solely supporting retirement phase accounts *at a time*, then those assets are deemed to be segregated pension assets at that time if the fund does not have DSFA

- Not necessarily documented in the fund's investment strategy
- Can have multiple periods of deemed segregation in a year
- Must use segregated method to claim ECPI from 2017-18 onwards

ECPI calculations prior to 1 July 2017

- ATO will not review calculations where a fund used the proportionate method over entire year even if there were periods where the fund was solely in pension

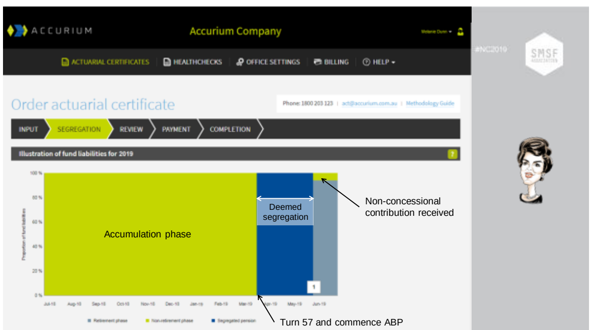
Does Smith Super Fund have DSFA?

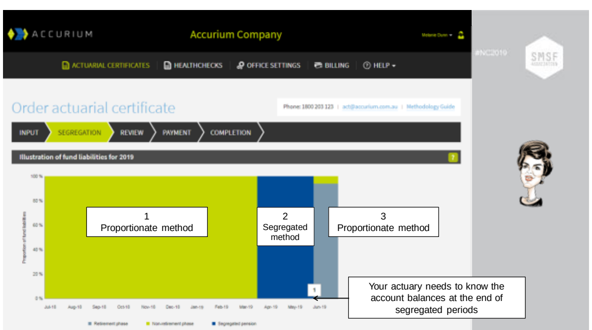
Jacqui O is the sole member of Smith Super Fund

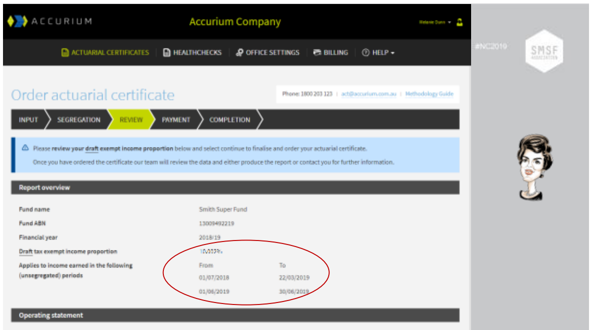
- Balance of $1,480,450 at 1 July 2018 in accumulation
- Commenced an ABP 23 March on her 57th birthday with her entire balance of $1,471,518
- Made a $100,000 non-concessional contribution and pension payment on 1 June
- She has no other superannuation accounts

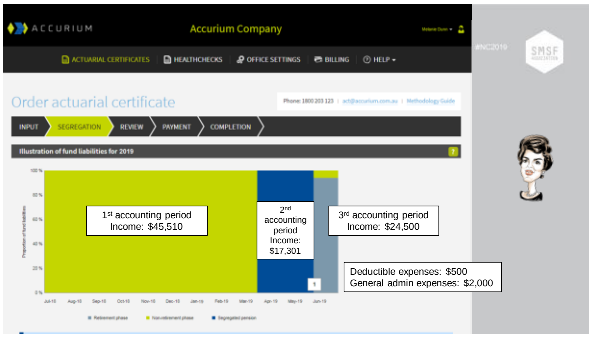
Does the fund have disregarded small fund assets in 2018-19? No

Would your answer change if her 30 June 2018 balance was over $1.6million? No





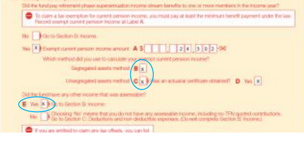




Smith Super Fund calculating ECPI

2018-19 ECPI = segregated method ECPI + proportionate method ECPI

- Segregated method ECPI = $17,301
- Proportionate method ECPI = 0.10002 x (45,510 + 24,500) = $7,002.40
- ECPI = 17,301 + 7,002.40 = $24,303.40



Smith Super Fund expenses

Expenses relate to fund assets both when deemed segregated and when not segregated

- Are not distinct and severable
- Total deduction = 500 + (deductible proportion x 2,000)

Actuarial method using (1 – exempt income proportion) is no longer fair and reasonable

- 1 – exempt income proportion = 1 – 0.10002 = 89.998%
- 89.998% of all fund assets are not producing assessable income
- Actuarial calculation does not include segregated assets and overstates a fair deduction

Need to allow for all fund liabilities, including segregated assets…

Smith Super Fund expenses

Jacqui uses the expense deductibility proportion in her actuarial certificate that takes into account all fund liabilities to apportion general expenses

- Allows for the deemed segregated periods and periods where assets not segregated
- Expense deductibility proportion 72.818%
- This identifies that 72.818% of all fund liabilities on average were non-retirement phase liabilities producing assessable income

Total deductions = 500 + (0.72818 x 2,000) = $1,956.36

Total non-deductible expenses = (0.27182 x 2,000) = $543.64

Capital gains and losses

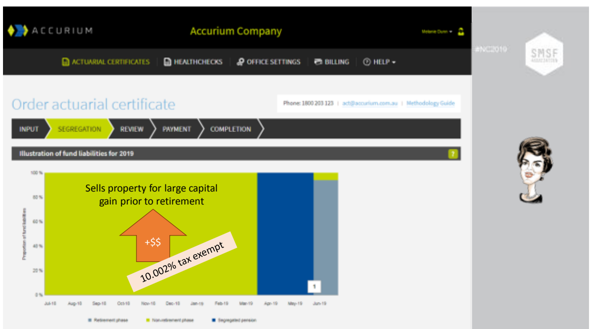
A fund with some periods in the income year where assets are solely supporting retirement phase, and other periods where there is a non-retirement phase balance

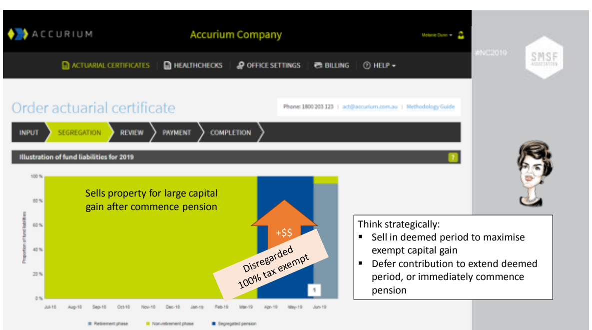
- *With* DSFA then irrespective of when gain/loss incurred net capital gain will have actuarial exempt income proportion apply and net capital loss can be carried forward
- *Without* DSFA then timing is important
  - A gain or loss incurred when fund solely in retirement phase will be disregarded
  - A net gain incurred when fund not solely in retirement phase will have the actuarial exempt income proportion apply and a net loss will be carried forward

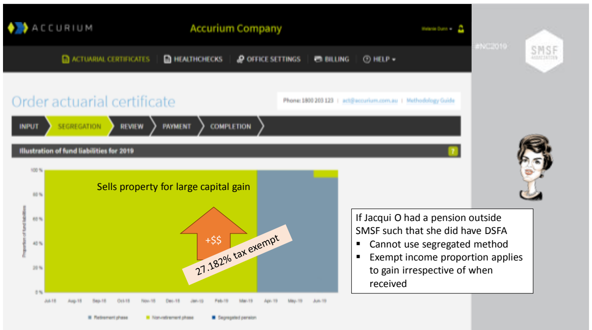
Smith Super Fund

In 2018-19 remember that Jacqui O commenced pension for the first time

- Smith Super Fund did not have DSFA and is eligible to use the segregated method
- Consider that during the year Jacqui was going to sell an asset for a capital gain to provide the fund with cash to make pension payments over the next few years
- The capital gain on a property owned by the fund will be significant at about $300,000







Disregarded small fund assets

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Whether tax outcome is better or worse depends on timing of income… either way the trustee has no choice and must use proportionate method over entire year to claim ECPI

- Applies to 2017-18 financial years onwards
- A fund can move in and out of disregarded small fund asset status each year
- A new member joining the fund could impact current year's status

Implementing this new administration requirement:

- You need to know all member's TSB each 30 June
- Important to know if a fund has DSFA when planning to realise capital gains or losses
- May also impact the deduction that can be claimed on fund expenses

A fund with periods solely in retirement phase, but at other times has non-retirement phase account

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If the fund *has* DSFA

- Must use proportionate method to claim ECPI
- Net capital gain has exempt income proportion apply, net capital loss can be carried forward, irrespective of timing of gains and losses
- Expenses that are not distinct and severable must be apportioned

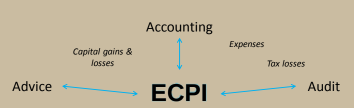
A fund with periods solely in retirement phase, but at other times has non-retirement phase account

If the fund does *not have* DSFA

- Must use segregated method in periods where deemed to be segregated and can use proportionate method to claim ECPI in other periods
- A net capital gain or loss in a deemed period will be disregarded – 100% exempt
- A net capital gain in a period where assets are not deemed to be segregated will have actuarial exempt income proportion apply, a net capital loss will be carried forward
- General administrative expenses relating to segregated assets will be non-deductible
- General administrative expenses which are not distinct and severable must be apportioned using a fair and reasonable method based on all fund assets

When is an actuary's certificate needed?

It can be complicated so keep our flow chart on hand to understand when a fund needs to use the proportionate vs segregated method



Understand the 'type' of fund you are dealing with:

- A fund which always has a non-retirement phase account during the year
- A fund which is solely in retirement phase over the whole year
- A fund which has periods where it is solely in retirement phase but at other times also has a non-retirement phase account
- A fund with assets elected to be segregated

Session 9B after morning tea

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Strategies to maximise ECPI on client's assets

- Using real life case studies we will highlight how important it is to plan ahead for ECPI and segregation as part of both the advice and accounting process
- Strategies for how advice can reduce administration costs and maximise ECPI

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