SMSF Association National Conference 2019

The ultimate guide to understanding ECPI and segregation

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SMSF ASSOCIATION

The ultimate guide to understanding ECPI and segregation

How a fund claims exempt current pension income (ECPI) impacts how it claims capital gains and losses, expense deductions and tax loss deductions in the annual return.

How a fund claims ECPI depends on the type of fund and the presentation identified four key fund types:

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

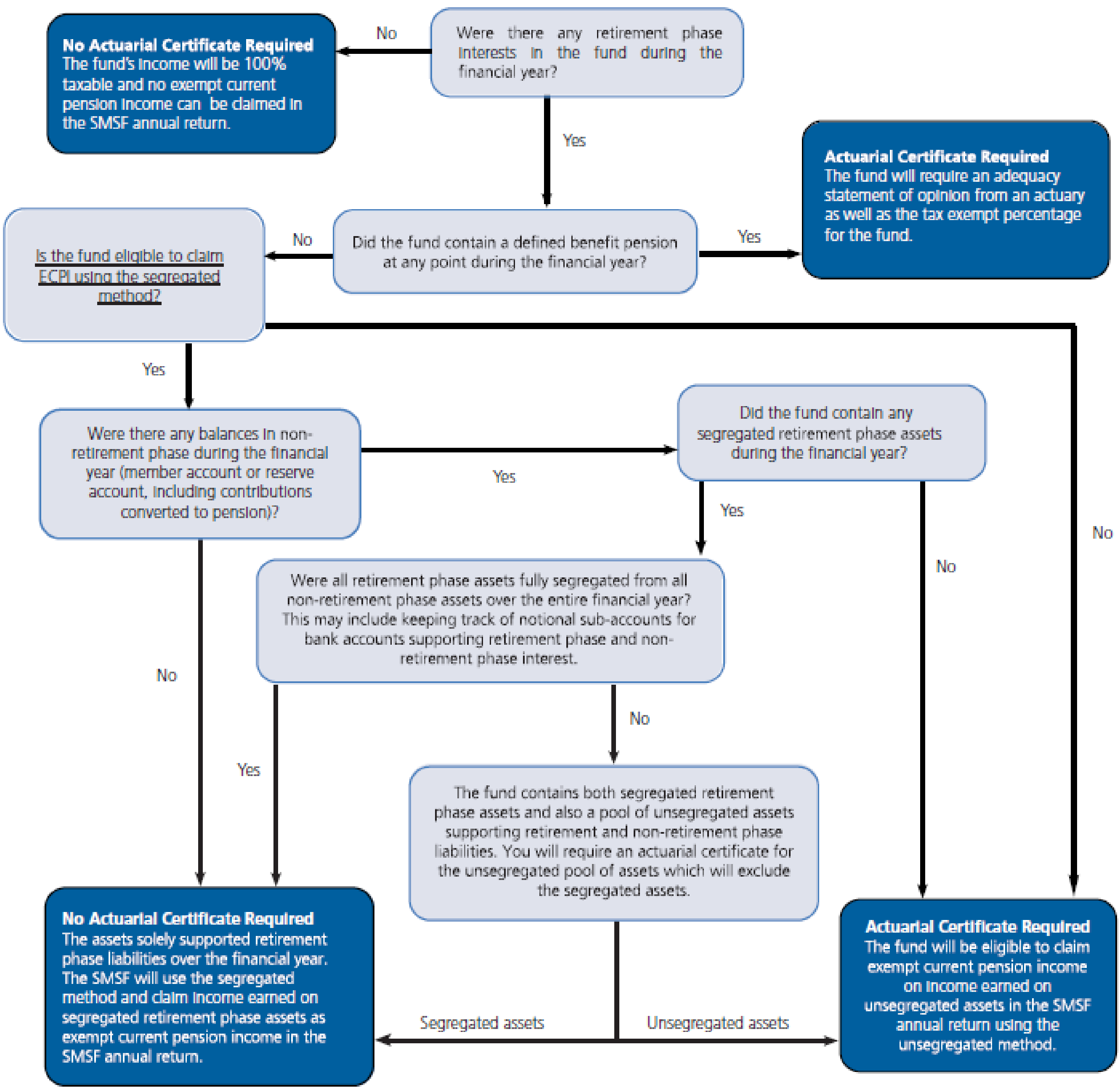
The first three represent the most common fund types and were discussed in the presentation. The fourth is a fund with elected segregation which is less common. For attendees interested in viewing a discussion on this type of fund Accurium has recorded a webinar looking at this fund type which can be found at www.accurium.com.au/techhub.

In addition to the above recording, this paper brings together a useful flow chart for when an actuarial certificate is required and three articles from Accurium's TechHub library which will further enhance your understanding of the topics covered in the presentation.

Disclaimer

Is an actuarial certificate required for the 2017-18 financial year?

The flow chart below outlines when an SMSF will require an actuarial certificate to claim exempt current pension income in the annual return for 2017-18 and future financial years in light of the new disregarded small fund asset and segregation rules.



Article 1: What is segregation?

Definition of segregated pension assets

An asset, or pool of assets, is a segregated pension asset for tax purposes if it is solely supporting retirement phase liabilities at a time in a financial year.

Where a self-managed super fund (SMSF) contains segregated pension assets, the income earned on those assets will be claimed as exempt current pension income (ECPI) using the segregated method.

Income Tax Assessment Act (ITAA) 1997 Section 295.385 defines segregated current pension assets. It says a fund's assets will be segregated current pension assets if (among other things) they are 'invested, held in reserve or otherwise dealt with at that time solely to enable the fund to discharge all or part of its liabilities (contingent or not), as they become due, in respect of superannuation income stream benefits that are RP superannuation income stream benefits of the fund at that time'[1].

Assets which are not segregated pension assets at a time in a financial year may still be eligible to claim ECPI, but will require an actuarial certificate and will claim ECPI by multiplying the actuarial exempt income proportion determined using the proportionate method (also known as the unsegregated method) by the income earned on assets which were not segregated pension assets. The calculation of the actuarial exempt income proportion using the proportionate meth-od, as defined in ITAA 1997 Section 295.390, will exclude any segregated pension assets. The exempt income proportion under the proportionate method is based on the average value of superannuation liabilities and does not include liabilities for which segregated current pension assets or segregated non-current assets are held.

Segregated non-current assets

An asset, or pool of assets, is said to be segregated non-current assets if the assets are solely supporting non-retirement phase liabilities and an actuarial certificate is obtained under ITAA 1997 Section 295.395.

Assets which are solely supporting accumulation interests in an SMSF are by default not segregated non-current assets. For example a fund which does not yet have a member in retirement phase. Earnings on accumulation assets are taxable, and in years where the fund has periods where it is solely in accumulation phase and periods where there is also a retirement phase interest will use the proportionate method to claim ECPI.

Segregated non-current assets will occur where assets are documented as part of the fund's investment strategy to be set aside to solely support accumulation phase interests, and the fund obtains an actuarial certificate. This is not common in an SMSF. If a fund does have segregated non-current assets

[1] Extracted from ITAA 1997 Section 295-385(4)

these will be excluded from the actuarial exempt income proportion calculation under the proportionate method and earnings on the segregated assets will be entirely taxable.

How an SMSF can have segregated pension assets

A fund can meet the definition of segregated pension assets in two ways:

- Deemed segregation
- Elected segregation

Deemed segregation occurs at any time all assets of the fund are supporting retirement phase superannuation income stream benefits e.g. account-based pensions or transition to retirement pensions in retirement phase. A fund's assets may have multiple periods of deemed segregation if members commence pensions or/and receive contributions in an income year meaning the fund moves into and out of solely being in retirement phase. Whether the fund has deemed segregation is a matter of fact based on the asset structure of the fund and transactions in the year and cannot be adjusted in arrears.

Elected segregation occurs where assets are documented as part of the fund's investment strategy to be set aside to solely support retirement phase interests. This may occur for example where a member wishes for a particular asset's income and expenses to be solely attributable to their retirement phase in the fund, and where they also want the fund to claim ECPI based on the elected segregation.

An asset which is elected to be segregated cannot exceed the value of the retirement phase interests to which it is attributed at any time, and the fund will need to ensure that the liquidity requirements of the retirement phase income streams are considered if segregating lumpy illiquid assets. Income earned on the segregated asset is claimed as ECPI and general expenses are not deductible. When a segregated asset is sold gains or losses are disregarded under the segregated method. In many cases a fund may also maintain a separate bank account or track notional sub-accounts in order to maintain the segregation where the asset is earning income e.g. rent on a commercial property.

Elected segregation is not common in an SMSF however deemed segregation may occur once the SMSF has a member who moves into retirement phase.

An exception to the definitions above is that assets which meet the definition of disregarded small fund assets cannot be segregated pension assets.

Disregarded small fund assets

A fund will have 'disregarded small fund assets' in a financial year, as defined in ITAA 1997 Section 295.387, and be ineligible to have segregated pension assets, if:

the SMSF has a retirement phase account at any time during the financial year in question; and

on 30 June just before the start of the financial year, a member of the fund had a total superannuation balance that exceeds $1.6 million and they also had a retirement phase income stream (this looks across all superannuation accounts of the member not just those in the SMSF).

If these two conditions are met the fund will have ‘disregarded small fund assets’ and will be unable to use the segregated method, either elected or deemed, to claim ECPI in that financial year. This test is done each financial year to determine how the fund must claim ECPI. A fund with disregarded small fund assets will not have any segregated pension assets and will claim ECPI using the proportionate method.

A quirk of this new rule is that it means we can have a situation where an SMSF may have only retirement-phase accounts but not be eligible to use the segregated method to claim ECPI.

For example, a sole member SMSF with a retirement phase income stream of less than $1.6 million but where the member also has a superannuation balance outside of the SMSF which brings their total superannuation balance above $1.6 million. This would result in the SMSF being solely in retirement phase for the financial year but will also meet the definition of ‘disregarded small fund assets’ and as such is unable to claim ECPI using the segregated method. This fund would be required to obtain an actuarial certificate and claim ECPI using the proportionate method.

Segregation for tax purposes vs segregation for investment purposes

Where a fund trustee wants to maintain elected segregation for investment purposes but not for tax purposes this is allowed even if the fund has disregarded small fund assets. This is an investment decision of the trustee and should be documented as part of the fund’s investment strategy. For example a trustee might set aside a pool of asset to support a member, or group of members, interests in the fund so that the income and expenses of those assets is solely allocated to those members. Unless the assets also meet the definition of segregated pension assets an actuarial certificate will be required to claim ECPI for tax purposes.

What is required for segregation?

The ATO website on the segregated method states that the trustee needs to consider whether the SMSF’s income stream assets meet the requirement of being ’segregated’ by determining whether:

- the assets are clearly identified as assets dedicated to funding super income stream benefits
- there is a clear relationship established between the relevant assets and the member’s account

For deemed segregation this is relatively simple. If all accounts in the SMSF are retirement phase income streams on a day and there are no accumulation accounts, reserve accounts or complying defined benefit income streams then the fund has deemed segregation on that day.

The following points, while not exhaustive, may assist in determining the requirements to be met for an asset to be a segregated pension asset using elected segregation.

A segregated asset needs to be completely separate

Part of an asset (e.g. part of a property) cannot be a segregated pension asset. The asset, or pool of assets, must be entirely segregated.

For example, consider a two member SMSF where Member One elects segregate an investment property to their account-based pension. The value of a property is less than the value of Member One's account-based pension and so the property is eligible to be segregated to support Member One's pension. In this scenario the fund would use the segregated method to claim ECPI in respect of the segregated property and claim ECPI under the proportionate method for income earned on all other assets of the fund. The trustee would obtain an actuarial certificate which will state the exempt income proportion that will apply to earnings on all assets of the fund except the segregated property.

Note that it is possible to segregate part of a bank account where notional sub-accounts are maintained in order to track the segregated part of the account. For example if Member One's property paid rent into the fund's general bank account the trustee could maintain notional sub-accounts to separately track the income and earnings in the bank account relating to the segregated asset, and those transactions and earnings that do not relate to the segregated asset.

Elected segregation needs to be documented

Segregation must be properly documented in the fund investment strategy. In addition, the decision to implement a segregation strategy should be in line with the fund's investment strategy and member objectives. For example, Jim and Jenny run their own SMSF and as part of their investment strategy review, after taking into account for example, the circumstances of the fund, their liquidity requirements, and each member's desired investment strategy and objectives, they decide it is appropriate to maintain a segregation strategy. They document that a decision had been made to allocate 10,000 BHP shares to solely support Jim's account-based pension from 1 July 2018.

The investment strategy of the fund should give consideration to the decisions made regarding segregation and any changes should be appropriately documented.

For example, if Jim and Jenny were primarily invested in term deposits and shares in line with a balanced portfolio, then by segregating 10,000 BHP shares to Jim he might be taking on a riskier investment profile than Jenny. This means that although the fund overall holds balanced assets, Jim holds more growth assets, and Jenny more defensive assets proportionately, and this should to align with the investment strategy documented by the trustees.

Cannot segregate purely for tax avoidance

Segregation must be justifiable based on various fund and member considerations. These considerations should not solely be a tax advantage. It is best practice to document and implement segregation strategies in advance and not in arrears. This is even more important in light of the ATO's focus on transfer balance account reporting and exempt current pension income for 2017-18.

For example, segregating a property to a pension on 1 July of the year it is sold for a large capital gain, then removing the segregation in the fund after 30 June when the gains have been received as tax exempt might look suspicious!

Conclusion

Segregation can be complicated and is generally more work. There are greater administration and documentation requirements due to keeping track of separate pools of assets and notional sub accounts for segregated bank accounts.

Many SMSFs are setup because Mum and Dad (and sometimes their children) wish to 'pool' their assets and make investment decisions as a family, for these funds segregation may not be part of their investment strategy.

However all income earned on segregated retirement phase assets is exempt income, and in particular capital gains incurred on such assets will be disregarded. Segregation strategies can therefore be attractive from a tax planning perspective.

Article 2: Disregarded Small Fund Assets

Introduced as part of the superannuation reforms the disregarded small fund assets legislation applies from the 2017-18 income year onwards and removes the ability of some SMSFs to use the segregated method for tax purposes.

Background

With a limit on the amount which can be transferred into retirement phase there was a thought that some trustees may attempt to circumnavigate the tax outcomes of the new transfer balance cap rules by using segregation.

A fund with both accumulation and retirement phase accounts due to the transfer balance cap would be required to claim ECPI using the proportionate (unsegregated) method and capital gains would not be fully tax exempt. By segregating assets to the retirement phase, a trustee would again be able to realise capital gains tax free. Disregarded small fund assets was introduced to stop this by disallowing the use of segregation for tax purposes, requiring those funds who meet the definition to use the proportionate method to claim ECPI on all assets.

When a fund has disregarded small fund assets

The disregarded small fund assets provision is defined in Section 295.387 of ITAA 1997. An SMSF will have disregarded small fund assets in an income year if:

> on 30 June just before the start of the income year, a member of the fund had a total superannuation balance of over $1.6 million and also has a retirement p phase income stream (the retirement phase income stream does not have to be in the SMSF);
>
> and
>
> the fund is paying a retirement phase income stream at some time during the income year in question.

This test is completed each year to determine how the fund must claim ECPI. If an SMSF has disregarded small fund assets the trustee must use the proportionate method to claim ECPI for that income year. This applies to all fund assets and so a fund will not have deemed segregation, nor have the option to treat assets as elected to be segregated, for tax purposes. The ATO has been clear that a fund can still segregate for investment purposes, for example electing in the fund's investment strategy to allocate assets to certain member accounts so that the income from those assets is allocated to that member's account, instead of allocating income on a proportional basis.

Administration of disregarded small fund assets

The legislation for disregarded small fund assets references a fixed value of $1.6 million for the test of total superannuation balance, rather than referring to the transfer balance cap which is indexed with inflation (and so likely to increase over time). This means that more funds may fall into the disregarded small fund assets definition over time.

Further, it is possible for an SMSF to have only retirement-phase accounts in an income year, but not be eligible to use the segregated method to claim ECPI. For example, a member may have a retirement phase incomes stream in their SMSF worth less than $1.6 million, but if the value of their super interests outside the SMSF increases their total superannuation balance above $1.6 million the SMSF would have disregarded small fund assets. This means the fund would need to use the proportionate method, and obtain an actuarial certificate, to claim ECPI in the annual return. The actuary's certificate would show an exempt income proportion of 100%. This anomaly was raised in a number of submissions to government on the draft legislation; however no changes were made in the final legislation.

The disregarded small fund assets provision also introduces additional administration requirements for SMSF professionals. In order to complete a tax return for an SMSF, tax agents will first need knowledge of each member's total superannuation assets at the prior 30 June in order to complete the disregarded small fund assets test. This test determines whether a fund is eligible to use the segregated method, which is critical to ensure ECPI is claimed correctly in the annual return.

For professionals who have previously only dealt with the SMSF accounts this means finding out new information about other superannuation accounts members may have, including industry, retail or government superannuation funds.

Case study

At 1 Jul 2017 John was the sole member of an SMSF. He had an account-based pension (ABP) balance of $1,400,000 and an accumulation balance of $110,000. John commenced a second ABP on 1 Feb 2018 with his entire accumulation balance of $125,000 at that date.

The SMSF earned $80,000 in assessable income over 2017-18.

The fund will be a mix of retirement and non-retirement phase from 1 Jul 2017 to 31 Jan 2018. From 1 Feb 2018 to 30 Jun 2018 the fund will be solely in retirement phase. The SMSF would not have disregarded small fund assets as John's total superannuation balance was only $1,510,000.

Based on the ATO view of deemed segregation the fund will claim ECPI using the proportionate method from 1 Jul 2017 to 31 Jan 2018 and must use the segregated method to claim ECPI from 1 Feb 2018 to 30 Jun 2018. The trustee determines that $60,000 of assessable income was earned from 1 Jul to 31 Jan and $20,000 of assessable income was earned from 1 Feb to 30 Jun. The exempt income proportion as determined by the actuary was 90.0%, which excludes the segregated current pension assets.

Applying the exempt income proportion to the $60,000 of assessable income earned on as- sets which were not deemed segregated gives exempt income of $54,000. Combined with the segregated pension income of $20,000 this gives a total amount of ECPI of $74,000.

If however we learn that at 1 Jul 2017 John also had an accumulation balance of $200,000 in a retail fund and so his total superannuation balance was actually $1,710,000. John's SMSF would then have met the definition of having disregarded small fund assets and would be unable to use the segregated method to claim ECPI in the 2017-18 income year.

Even though the SMSF is entirely in retirement phase from 1 Feb 2018 to 30 Jun 2018 the proportionate method must be used over the entire income year.

An amended actuarial certificate is applied for and the actuary determines the exempt income proportion using the proportionate method for the full income year to be 95.0%.

Applying this exempt income proportion of 95.0% to the full year assessable income of $80,000 the amount of ECPI the trustee can claim in the annual return is $76,000.

In this scenario the fund would actually have under-claimed ECPI in the annual return if they did not correctly allow for disregarded small fund assets when completing the annual return.

In practice disregarded small fund assets could lead to a better or worse tax outcome depending on the timing and size of income earned over the year. However remember that the fund does not have a choice where it has disregarded small fund assets, it must use the proportionate method.

Conclusion

The ATO have identified that ECPI is an ongoing area of compliance focus for SMSFs and so it is more important than ever to ensure ECPI is claimed correctly in the annual return.

The disregarded small fund assets test must be completed every income year in order to determine how to claim ECPI. The annual return can no longer be completed in isolation but requires knowledge of superannuation accounts for each member outside the SMSF. However it is critical that when applying for the fund's actuarial certificate you have the answer to 'does the fund have disregarded small fund assets?' on hand as this is required in order for actuaries to correctly calculate the fund's exempt income proportion used to claim ECPI.

Article 3: Technical guide to the deductibility of expenses in an SMSF

The discussion in this paper relates only to expenditure of a superannuation fund which is not of a capital, private or domestic nature.

The ATO Tax Ruling 93/17 sets out general principles for tax deductibility of expenditure in an SMSF. Generally, expenditure of a superannuation fund which is not of a capital, private or domestic nature, is deductible under section 8-1 of the Income Tax Assessment Act 1997 to the extent the expense was incurred in gaining or producing assessable income.

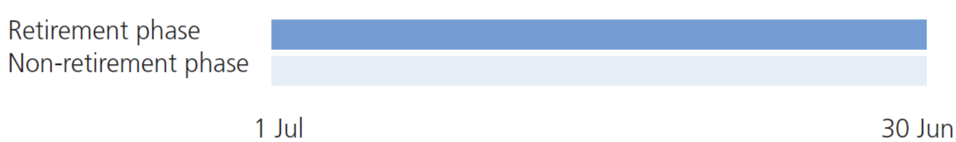
The superannuation reforms applying from 1 July 2017 combined with the ATO's updated view on when an SMSF has segregated pension assets has impacted how a fund must claim ECPI for 2017-18 and future income years. Although no changes were made to the principles for deductibility of expenditure by an SMSF, the changes to ECPI may impact the method trustees use to claim a deduction on expenses which must be apportioned.

Expenses which don't need to be apportioned

Expenses incurred on assets that were solely producing exempt income will not be deductible.

For a fund solely in retirement phase for an income year:

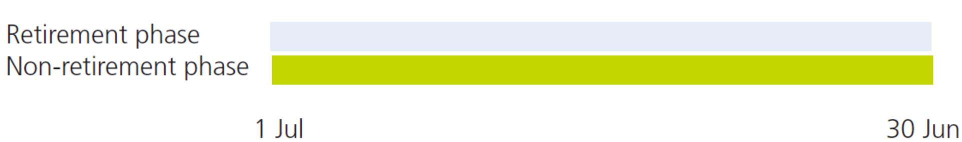
- All assets are supporting retirement phase accounts producing exempt income
- Income will be claimed as ECPI in the annual return
- Expenses incurred are not deductible in the annual return



Expenses incurred on assets that were solely producing assessable income will be fully deductible.

For a fund solely in non-retirement phase for an income year:

- All assets are supporting non-retirement phase accounts producing assessable income
- No income can be claimed as ECPI in the annual return
- Expenses incurred are fully deductible in the annual return



Expenses which need to be apportioned

Expenses incurred on assets that were not solely producing exempt income or solely producing assessable income need to be apportioned. A relevant expense can be claimed as deductible to the extent it was incurred in producing assessable income.

There is not a prescribed method for calculating the deductibility of expenses that must be apportioned. An approach that would be justifiable to the Commissioner of Taxation as fair and reasonable should be used. Methods commonly used for apportionment are:

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

The actuarial exempt income proportion provided in an SMSF's actuarial certificate represents the proportion of the fund liabilities in retirement phase on average over the income year. This represents the proportion of fund assets generating exempt income over the income year, and so one minus this value estimates the proportion of fund assets over the year generating assessable income. This deductibility proportion is easy to calculate and is widely used. It may be fair and reasonable for expenses relating to assets of the fund over the given income year.

The TR 93/17 method extends on the actuarial exempt income proportion method to include contributions and rollovers. For a given income year the deductibility proportion is calculated by determining the fund's assessable income and dividing that by total income where concessional contributions (CC), non-concessional contributions (NCC) and rollovers are added to assessable income.

TR 93/18 deductibility proportion =

$$\frac{\text{assessable income x actuary's exempt income proportion + NCC + CC + rollovers}}{\text{assessable income + NCC + CC + rollovers}}$$

Although more work, generally the TR 93/17 method will provide a greater deduction than the actuarial method where there are contributions or rollovers received during the income year.

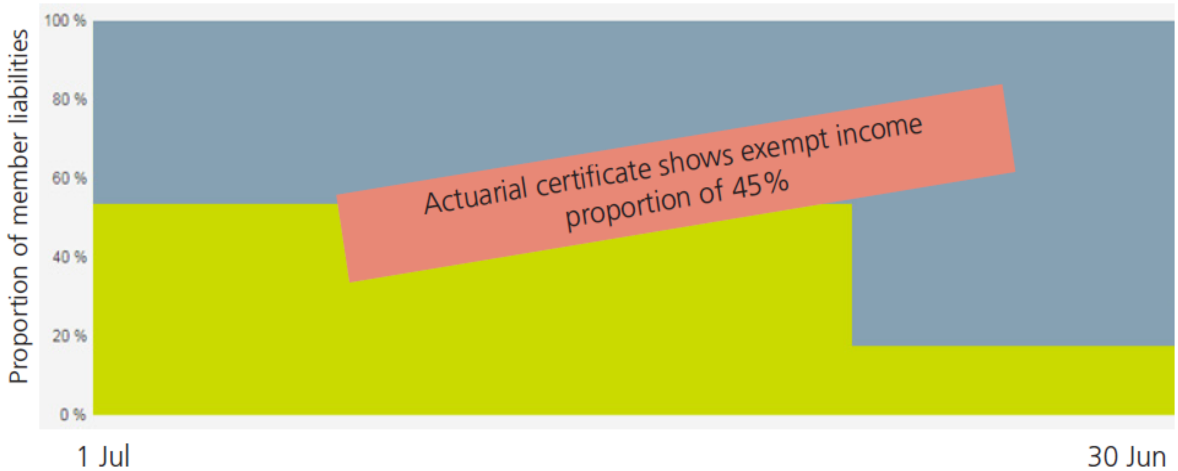
Example: apportionment over an income year

Consider a fund with both retirement phase and non-retirement phase interests over an entire year:

- The fund had three members: Harold, Meg and their son Charlie
- At 1 Jul 17 Harold was receiving an ABP whereas Meg and Charlie were in accumulation phase
- In Mar 18 Meg turned 65 and commenced an account-based pension with her entire balance
- On 30 Jun 18 Charlie made a $50,000 NCC to the fund
- During 2017-18 income year $20,000 in income was earned

The chart below illustrates the fund liabilities over the 2017-18 income year.

Grey represents the proportion of fund liabilities in pension, and green the liabilities in accumulation:



The fund had no segregated pension assets over the 2017-18 year and will use the proportionate method to claim ECPI on all fund income. The actuary's certificate provided the fund with an exempt income proportion of 45%.

The fund incurred deductible expenses of $2,000. These need to be apportioned as the fund's assets were producing both exempt and assessable income over the income year to which the expenses relate.

The trustees decide to apportion expenses based on (1 – exempt income proportion). This provides a deductibility proportion of (1 – 0.45) = 55%. Approximately 55% of fund liabilities over the 2017-18 income year were supporting non-retirement phase liabilities producing assessable income, on average.

The deductible proportion of the $2,000 expenses $1,100 (2,000 x 0.55). This amount can be claimed as a deduction in the SMSF annual return.

If the trustees instead used the TR 93/17 method which allows for the inclusion of contributions this may give a greater deduction. The deductible proportion would be determined as:

- Total income = $20,000
- Actuarial exempt income proportion = 45%
- Exempt income = 45% x $20,000 = $9,000
- Deducibility proportion = assessable income / total income
  = ($20,000 - $9,000 + $50,000) / ($20,000 + $50,000)
  = 87.1%

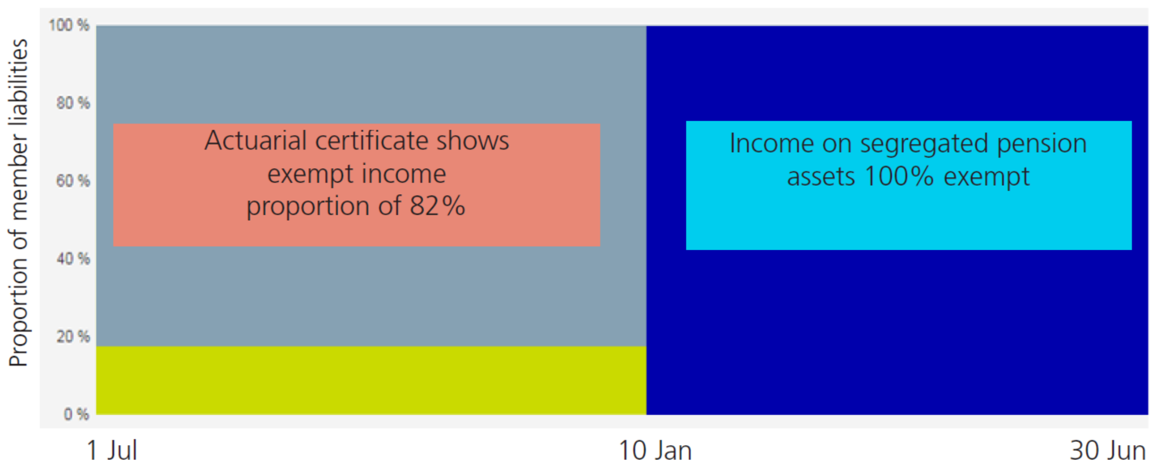
The deductible proportion of the $2,000 expenses would be $1,742 (2,000 x 0.871) if the trustees used this method.

What's changed in 2017-18 when claiming a deduction on fund expenses

For the 2017-18 income year onwards the method of using (1 – actuarial exempt income proportion) may no longer be considered fair and reasonable where the fund had periods of deemed segregation. This is because the calculation of the exempt income proportion excludes liabilities in relation to segregated current pension assets that were solely producing exempt income. It will not be based on all assets over the entire financial year and may therefore overstate a fair and reasonable deductibility proportion for expenses relating to the full income year.

Example: fund with deemed segregation

Consider a fund with member Chris who has a non-retirement phase TRIS and his wife Beryl who has an account-based pension at 1 Jul 2017. On 10 Jan 2018 Chris retired and his TRIS converted to retirement phase. The fund does not have disregarded small fund assets.



From 1 Jul 2017 to 9 Jan the fund had both retirement phase and non-retirement phase accounts. Assets in this period are producing a mix of exempt and assessable income. From 10 January 2018 all fund assets are supported by retirement phase accounts and the fund is deemed to have segregated current pension assets.

The fund will claim ECPI using both proportionate and segregated method. The actuary's certificate excludes the liabilities in the period where assets were deemed to be segregated and will apply only to income earned from 1 Jul to 9 Jan. Income earned from 10 Jan to 30 Jun will be exempt income.

If an expense incurred in the 2017-18 year is distinct and severable and relates solely to assets that were solely in retirement phase then the expense is not deductible. However, if an expense relates to assets that were not solely producing exempt income then the expense must be apportioned.

The fund incurred expenses that relate to assets over the entire 2017-18 income year of $5,000. In prior years the trustee has used the actuarial method to claim a deduction on similar fund expenses.

The deductibility proportion of (1 – exempt income proportion) is calculated as 18% (1 – 0.82). However, this is not a fair and reasonable deductibility proportion because the expenses don't just relate to assets in the fund from 1 July to 9 January, but relates to the entire income year. Since the rest of the year is solely producing exempt income a deductibility proportion of 18% for an expense relating to the entire income year will overstate a fair and reasonable deduction.

For the actuarial method to remain fair and reasonable we need to re-calculate the exempt income proportion allowing for all liabilities over the income year. We want to determine the proportion of fund assets on average over the entire income year that were supporting retirement phase liabilities, not just not just those up until 10 January.

If we re-do the calculation including all liabilities from 1 Jul 2017 to 30 Jun 2018 then the result is 91%. This approach is likely to be considered fair and reasonable and gives a deductibility proportion of 9% (1 – 0.91). Approximately 9% of fund liabilities over the income year, on average, were supporting non-retirement phase liabilities producing assessable income.

The deductible amount of the expenses = 5,000 x 0.9 = $450

This compares to $900 (5,000 x 0.18) if we had just used the actuarial method based on (1 – actuarial exempt income proportion).

Conclusion

The actuarial method remains an easy to calculate method that can provide a fair and reasonable deduction of expenses that must be apportioned over an income year. However, remember that where a fund has segregated current pension assets the actuarial exempt income proportion will not take account of those assets solely producing exempt income. As such (1 – actuarial exempt income proportion) may overstate a fair and reasonable deduction of expenses. Instead a calculation needs to be completed to provide a proportion that takes into account the whole income year.

A fair and reasonable method would use the proportion of fund liabilities on average over the income year that are supporting non-retirement phase assets producing assessable income. This will be the same as (1 – actuarial exempt income proportion) where the fund has no segregated pension assets, but will be different if the fund does have segregated pension assets.

To assist trustees in continuing to use the actuarial approach to claiming a deduction on expense that must be apportioned Accurium actuarial certificates now include a calculation of an expense deductibility proportion based on a full income year in addition to the required actuarial exempt income proportion used for claiming ECPI.