Exempt Current Pension Income New Rules and Strategies

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New Rules and Strategies

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Exempt Pension Income Deduction

If SMSF has un-segregated assets (accumulation and pension assets are mixed) and paying an income stream benefit to a member then you need an Actuarial certificate, every year, to claim Exempt Pension Income.

Actuary's role is to calculate and prepare a certificate which determines percentage of tax exemption of total income. You need this certificate before your fund is audited each year.

When income of a SMSF is exempt from tax

Income Tax liability of a SMSF is dependent upon whether the fund is in accumulation or pension phase or a combination of both. A SMSF is in accumulation phase when ALL members are making contributions to the fund and during accumulation phase Income of SMSF is taxed at the rate of 15%.

SMSF is in pension phase when at least one member is drawing an income stream benefit or pension (usually account based pension) from the fund. When all members of the fund are drawing an income stream then ordinary income earned by the SMSF is exempt from Income tax and you do not need an actuarial certificate.

But when a SMSF has a combination of both type of members, i.e. some members of the fund are in accumulation phase and some members are withdrawing pension. If the fund is a one member fund, the member has a pension account and is contributing to the fund, such as in case of 'Transition to retirement income stream'. Then the fund needs an actuarial certificate.

When the fund's assets are not segregated (accumulation assets are not separate from pension assets) then part of a fund's income could be taxable and part could be exempt.

This exempt proportion (or percentage) of the fund's income is dependent upon value of opening balance of pension / accumulation assets and the value of average pension liabilities relative to total value of fund balance.

Total income is declared in the income tax return of the fund and the exempt pension income is claimed as a deduction to calculate taxable income of the fund. Note that all deductible (concessional) contributions always are taxable and pay tax @ 15%.

To claim this deduction for exempt current pension income (ECPI), ITAA 1997 Section 295 -390 requires that an actuarial certificate determining ECPI percentage is calculated by a qualified and licensed actuary.

When an actuarial certificate is needed?

When a SMSF commences a pension, ordinary income earned on assets supporting the pension is exempt from Income tax. This income is commonly referred to as Exempt Current Pension Income (ECPI). To claim this exemption two methods can be used.

Segregated assets method: Where assets specifically supporting a pension are set aside, like investments in Term deposits or shares equivalent to balance in pension accounts. These assets do not mix with other assets of the fund.

Un-segregated assets method: Where assets representing accumulation balances and supporting pensions are mixed up and cannot be separately identified.

Funds using the segregated assets method do not need an actuarial certificate. But if the fund is using un- segregated method, for claiming ECPI an actuarial certificate is needed which certifies the proportion of exempt income.

Examples of situations when an actuarial certificate is needed:

- Some members of the fund are in accumulation phase and some in pension phase.
- A member is drawing Transition to retirement Income stream where he is drawing pension and the fund is receiving contributions as well for the member.
- If one member started the year with an accumulation account but during the year this account gets converted into a pension account.

Examples of situations when an actuarial certificate will not be needed:

- Where all the members are in accumulation phase for whole of the year.
- Where all the members are in pension phase for whole of the year.
- Where the fund is using the segregated assets method

Examples with un-segregated assets

Examples	Actuary certificate required
Michael is drawing a pension, Mary is still in accumulation phase	Yes Assets are un-segregated
Michael (single member) is drawing a Transition to Retirement income stream and his employer is contributing to the fund	Yes Some assets are in Accumulation

Michael and Mary are both drawing pensions and are not contributing	No Fund is segregated
On 1 July, Michael and Mary commence drawing pensions from the fund – there are no new contributions to the fund	No Fund is segregated
Michael is drawing a pension, he is the only member of the fund. He then makes a $450,000 contribution into the SMSF. - He leaves the money in accumulation	Yes Some assets are in Accumulation
Michael is drawing a pension, he is the only member of the fund. He then makes a $450,000 contribution into the SMSF - He commences a pension immediately	No Fund is segregated
Michael was drawing a pension and died on 1st Jan. The money is paid from the SMSF as a lump sum to his estate after all assets are sold on 15th May.	No On death the account remains in pension phase

To Segregate Assets or not

Some funds can be relatively simple to fully segregate assets to avoid the need for an actuarial certificate, however, please note that segregation of assets requires a lot more administration work i.e. identifying and recording assets separately / separate bank accounts / allocation of each common expense (e.g. audit fees) in a manner that will satisfy the regulator and your auditor.

The un-segregated (mixed) approach is easier to manage and administer, where all fund assets are pooled together and a percentage of the pooled assets are paying a pension and remainder assets are in accumulation phase. Actuarial certificate then determines the percentage of income of the total income which is exempt pension income.

Income Tax Act Section 295 – 385 & SIS Regulations. 9.31

(Adequacy laws as per the Superannuation Industry Supervision Regulations 1994)

There is a requirement of all SMSFs paying defined benefit pensions (lifetime, life expectancy, Term certain, flexi), the actuarial valuation of a fund's net assets determines whether there is a "high degree of probability that the fund will be able to pay the pension as required under the fund's governing rules".

Centrelink pensioner receiving a defined benefit pension would also require a certificate each year.

Accounting for expenses in SMSF with Exempt Pension Income

Where assets of a self managed super fund are un-segregated an actuary can only issue a certificate on how much income is exempt from tax, known as Exempt Current Pension Income (ECPI).

Expenses incurred in gaining or producing exempt or non-assessable non-exempt income, or expenses of a capital, private or domestic nature are not allowable deductions. If the fund has only expenses which the SMSF incurs in deriving only ECPI, they cannot be claimed anywhere on the SMSF annual return.

If the expense is incurred which relates to accumulation and pension income, the expense must be apportioned so that only the proportion of the expense relating to the production of assessable income is claimed.

Claiming expenses

If your SMSF is not just solely paying a pension, that is, there are members who are still in accumulation phase, you should clearly identify what expenses you have and how much is related to the income earned to pay pensions. The reason for this is, if you are entitled to a tax exemption on the income that is used to pay current pension liabilities you won't get a deduction for the expenses related to earning that exempt income and you can't claim these expenses as a deduction in the fund's income tax return.

Example

For example, if the fund pension and non pension assets are un-segregated or they cannot be identified separately, then all expenses may not be deductible, you will have to apportion them.

Say Michael is 62 years old and has $500,000 in pension phase and his spouse Mary who is 52 years old is still in accumulation phase and has $250,000 in her accumulation account, there are no new contributions by any member. The Super fund owns one commercial property worth $700,000 and there is bank account with $50,000 since there is only one large asset, the fund cannot be segregated.

The fund has expenses such as insurance, strata, water rates etc relating to the commercial property for $6,000 – since Michael is on pension - the actuary determines that 66.66% of income is exempt; this means that the fund cannot claim $4,000 worth of common expenses. Only $2,000 worth of expenses can only be claimed by the fund which is 33% of the fund belonging to Mary.

Expenses which a SMSF incurs in deriving ECPI cannot be claimed anywhere on the SMSF annual return. This means that these expenses must not be included as part of the deductions claimed in the SMSF annual return and $4,000 will not be disclosed in the income tax return.

Specific expenses

The cost of amending trust deeds are allowable as a deduction provided the expenditure is not of a capital nature (Taxation Ruling IT 2672). Supervisory levy for an annual return to the ATO is deductible as a tax-related expense; however, late lodgement amount of the levy is not deductible.

Taxation Ruling 93/17 guides on how specific expenditure such as actuarial costs, accountancy fees, audit fees etc can be apportioned which are incurred partly in producing assessable income and partly in gaining exempt income. If you have Total and Permanent Disability cover in your SMSF, you should read Taxation Ruling TR 2011/D6 for further information.

If some expenses which are deductible to accumulation account are specifically recorded and marked to accumulation account, like life insurance for Mary in the above example, then that life insurance expense is fully deductible to the fund. This means if one member has both, a pension account and an accumulation account in a self managed super fund, the fund must record expenses in such a manner that expenses which are 100% deductible are linked to accumulation account and are recorded accordingly and claimed fully.

Treatment of Special Income and contributions

Special income such as non-arm's length income includes income such as private company dividends (including non-share dividends) and certain distributions from private trusts. Non-arm's length income and assessable contributions are excluded from ordinary income and cannot be exempted from income tax.

Mid year pensions

One of the common strategies is to commence a transition to retirement pension as soon as the members reach their preservation age (usually 56 years). This can

happen on the member’s birthday which can be any date other than 1st July in the year.

Advisor should add contributions from 1st July to the 56th birthday and prepare accounts of the fund and allocate income to all members, including unrealised gain or loss.

These interim (56th Birthday) accounts should also account for tax on income & contributions to date and credit (or debit) member accounts with growth (loss) in market value of all assets. Once the member balance is credited (or debited) with all realised and non-realized income & contributions a new member balance is determined for the accumulation account which is then converted to Pension phase.

This new member balance determines the amount of minimum pension withdrawal which the member must withdraw prior to 30th June to maintain pension standards. The minimum withdrawal amount is pro-rata for the balance number of days up to 30th June. The maximum amount which can be withdrawn for transition to retirement pension is not more than 10% of the pension commencement balance and is not pro-rata.

We strongly recommend proper pension documents to be drawn up and pension agreement to determine important issues such as commencement date of pension, tax free and taxable components of the member balance, percentage of accumulation account to be converted to pension phase, frequency and amount of pension payments, reversionary pensioner and what happens to the pension amount on death of the member etc.

Problem with mid-year pensions

Preparing income tax return for the fund which has commenced a pension during the year can be daunting. Any income from 1st July to the commencement date of pension and from commencement date of pension to 30th June is put together in the income tax return.

Whilst calculating actuarial percentage and exempt pension income deduction, the percentage of ECPI deduction is based on the assumption that income is earned consistently during the whole year. Hence it will be wrong to assume that any capital gain triggered and realized after the pension commencement date will be tax free.

Any capital gain realized after the commencement of pension will be part of total income and the fund will be able to claim a deduction as per actuarial ECPI percentage.

If the intention is to sell assets after commencement of pension, it is of paramount importance that assets must be either segregated or the asset sold the following year. Trustees should take capital gain tax advice before selling any assets after commencement of mid-year pensions.

Similar problems are faced when a pensioner dies mid-year. The ATO has released a tax ruling setting out its views on when pension commences and ceases on death. Note that pension balance of the member remains in pension phase till the death benefits are paid out or an automatic revision is provided in pension documents or death benefit nomination.

Tax losses

Super funds can borrow. Due to “Super Negative Gearing”, it is possible for a SMSF to be in a revenue loss situation. These losses (not capital losses) can be used to offset other income of the fund including a tax shelter for concessional contributions. In the absence of any concessional contributions, these losses are carried forward to the following year.

However, if the fund has any exempt pension income any carried forward loss is reduced by Net Exempt Pension Income claimed by the fund. The net ECPI amount is ECPI less any expenses that were incurred in deriving ECPI (such expenses cannot be claimed as a deduction).

If the fund has carried forward losses and no member will contribute to the fund and the whole fund moves to pension phase, all losses including capital losses are practically lost.

This can be explained by an example:

Zanzibar Super Fund has two members; Kuku who has 80% assets on pension while Dodo has 20% who is still in accumulation phase. The fund has carried forward losses of $100,000 from previous years. The fund earned $60,000 interest income and incurred $1,000 bank fees. The assets of the fund are un-segregated. Since bank fees were incurred in earning both assessable income and exempt income, they have to be apportioned accordingly.

Exempt pension income deduction will be 80% of $60.000 or $48,000 only $12,000 will be assessable income. Out of the $1,000 bank fees, $800 (80% of $1,000) will not be claimed as a deduction. Hence Net ECPI is $47,200 ($48,000 less $800).

Since the carried forward loss is $100.000 only $52,800 ($100,000 less $47,200) can be used against taxable income of $11,800 ($12,000 less $200 deductible bank fees) and only $41,000 loss can be carried forward ($52,800 less $11,800) to the following year.

In other words, loss of $100,000 is now reduced to $41,000 after $59,000 (income $60,000 less $1,000 of bank fees) of income for the year.

Capital Gain and loss

If your SMSF has segregated current pension assets, you should ignore any capital gains or capital losses resulting from the disposal of these assets. Any such capital loss cannot be offset against any other capital gain earned by the SMSF.

However, if your SMSF has un-segregated current pension assets and the fund has a net capital loss, the loss can be carried forward each year until it can be offset against an assessable capital gain. Any net capital gain is added to the SMSF's assessable income before working out how much of income is tax exempt, as per the actuarial calculation for the relevant year.

Strategies

There are strategies available to increase ECPI, such as;

Commence pension early

If condition of release (age of member) for the pension has been reached and the minimum pension requirements are satisfied, then making the pension commencement date as early as possible will improve the tax free percentage.

Minimum pension not withdrawn

The fund is not entitled to claim any amount for exempt pension income under either Section 295-385 or 295-390 if the minimum prescribed amount is not withdrawn. If no amount is withdrawn then exempt percentage cannot be claimed, then the only alternative is to convert the fund back to accumulation phase. However, if the member is above 56 years but below 59 years of age it is possible to include the minimum withdrawal amount as PAYG withholding amount and issue a PAYG payment summary with the same amount as payment withheld.

For example Smith Family Super fund has only one member, Rodney Smith who was 56 years old as on 1st July 2010 and had $1,000,000 in pension phase; there is no accumulation account as on that date. In the 2010 / 11 year, his employer contributed $50,000 as employer contributions and as salary sacrifice by quarterly instalments. The fund earned $200,000 as capital gain, interest and dividend income. Rodney was required to withdraw minimum of 4% (half minimum allowed) before 30th June 2011 but he forgot to withdraw any amount.

The advisor can issue a PAYG certificate with a gross and tax amount of $20,000 and remit $20,000 to ATO for PAYG withholding after 30th June 2011 and still have the fund in pension phase and claim a percentage of ECPI instead of paying income tax @ 15% on $200,000 income.

Less than minimum amount withdrawn

It is possible to roll back part of the purchase price of pension back to accumulation phase to ensure that minimum withdrawal is in sync with the pension amount.

Assume the same example above, but this time Rodney is over 62 year old and instead of withdrawing no amount, he withdraws only $10,000.

The way to fix this problem is to roll back $1,000,000 pension amount to accumulation account as on 1st July 2010 and commence a pension with only $500,000 and leave the balance in accumulation account. This strategy will at least save half the tax as some balance would be in pension phase and the minimum pension payments will now be satisfied as it is sync with the pension amount withdrawn ($10,000 is 2% of $500,000). Extreme care is required for this strategy as the trust deed must allow for internal roll over.

Payment of death benefit

The ATO has issued a ruling that the pension mode stops on date of death of the pensioner, however the pension will continue till all the benefits are paid out within a reasonable time. Any income or realised gains on assets sold to pay lump sum superannuation death benefits will be fully exempt if assets are segregated for the pensioner. If assets are un-segregated, some of the capital gain may become tax free for assets paying a pension.

Time of withdrawal

The higher the pension account, the favourable the ECPI percentage. This means that pensioner should delay, if circumstances permit, to withdraw the minimum amount till the last week of the financial year.