TAX TALKS

Australia's Tax News Podcast - The Podcast for Australian Tax Professionals

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Segregation and exempt current pension income (ECPI) go hand in hand. You can't talk about the one without the other. Both are key features for professionals dealing with SMSFs in retirement.

Here is what we learned from our interview with Melanie Dunn of Accurium. But please listen to the interview. Melanie explains it much better than we ever could.

Segregation

ECPI stands for exempt current pension income. It is the income exempt from income tax based on the proportion of assets supporting retirement phase liabilities over an income year. It does not apply to non-arm's length income or assessable contributions.

To be eligible for ECPI the fund must meet minimum pension standards including minimum pension payments.

You find the amount of ECPI in Section A Item 10 of the SMSF Annual Return.

Segregation occurs when a trustee sets assets aside to support a specific pension liability (the official term is now retirement phase income stream liability), or by default when assets are solely supporting retirement phase income streams.

Liabilities

An actuary calculates ECPI based on liabilities. It all depends on whether a liability is a retirement phase liability or not.

Retirement phase liabilities consist of account-based pensions (ABP), market linked income streams and transition to retirement income streams (TRIS) in retirement phase.

Non-retirement phase liabilities consist of accumulation accounts, reserves and TRIS not in retirement phase.

Defined benefit pensions are usually a mix of retirement and non-retirement phase liabilities.

Non-Retirement Phase TRIS

A 'non-retirement phase' TRIS no longer has tax exempt status as from 1 July 2017. Since not in retirement phase, they don'tcount towards claiming ECPI. A tax rate of 15% applies to these earnings, lower if offset by deductible expenses.

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A non-retirement phase TRIS does not raise a transfer balance account (TBA) credit at 1 July 2017 or upon commencement nor other TBAR events. But it is still an income stream, so must make minimum pension payments.

Retirement Phase TRIS

A TRIS starts being in tax free 'retirement phase' either automatically upon attaining age 65 or once the trustee is notified that the member has satisfied a condition of release with nil cashing restrictions.

Once this happens, the member's TBA receives a credit and the fund will need to lodge a TBAR. The TRIS is now eligible to count towards claiming ECPI, aka tax free earnings.

A retirement phase TRIS is not an ABP. The ATO's view is that the law does not facilitate an 'auto conversion' from a TRIS to an ABP, even when a nil cashing restriction condition of release has been met.

However, once in retirement phase the TRIS is no longer subject to 10% maximum payments and commutation restrictions. Just like an ABP a TRIS in retirement phase can make lump sum payments. The TBAR needs to show these payments. And they don't count towards minimum pension payments. However, be aware of rules written into fund documentation, for example deed or pension documentation might limit payments to 10%.

When a TRIS converts to retirement phase, it doesn't need to recalculate minimum pension payments. Also, if a member under 65 started a TRIS in retirement phase but then returns to work, the existing TRIS remains in retirement phase.

The alternative to moving a TRIS to retirement phase is to cease the TRIS and start an ABP. But be really careful about this, since it might impact tax components.

Segregated Pension Assets

Segregated pension assets are those solely supporting retirement phase liabilities.

You claim ECPI under section 295.385 of ITAA 1997 since the income on segregated assets is exempt current pension income and capital gains and losses are disregarded. You don't need an actuarial certificate.

There are two types of segregation. They are elected segregation and deemed segregation.

Elected Segregation

Elected segregation is segregation for tax purposes. You elect an asset or pool of assets to support a retirement phase income stream. But you cannot segregate parts of an asset.

You must document the segregation in the fund's investment strategy and may need notional sub-accounts to maintain segregation on bank accounts. The segregation impacts a member's risk profile. Liquidity can also be an issue meaning the segregated pool might run out of cash to pay the minimum pension.

You claim ECPI on earnings using the segregated method as 100% tax exempt, no actuarial certificate required.

Example

Member 1 (M1) ABP $850,000 and Member 2 (M2) has $150,000 with SMSF assets in a balanced investment mix. M1 now elects to segregate a property valued at $800,000. All other assets remain pooled supporting M2's accumulation interest and the remainder of M1's pension interest.

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M1 now pays minimum pension payment of $42,500 resulting in an ABP balance of $807,500. M1 now only has $7,500 in assets that are not assets elected as segregated ….liquidity issues. The next year M1 takes payment of $15,000…resulting in an ABP balance of $792,500. So now the segregated asset value exceeds the relevant ABP so can no longer be segregated. Segregation stops.

Deemed Segregation

Deemed segregation occurs for periods where fund is solely in retirement phase. If the SMSF solely supports retirement phase accounts *at a time*in the year, then it must use the segregated method to claim ECPI in those periods.

The result is that an SMSF can have multiple deemed segregation periods in a financial year.

The ATO has advised that it will not review ECPI calculations for periods prior to 1 July 2017 where the fund used the proportionate method over the entire year although the fund had periods where the fund was solely in pension during the year.

From from 1 July 2017 onwards there is no longer a choice. The fund must use the segregated method in periods where the fund is solely in retirement phase. And it must use the proportionate method for periods where it had assets which were not segregated.

Momentary Accumulation Account

Sometimes a Fund can have a momentary accumulation balance in the year, for example if the fund commences a pension on 1 July with its entire accumulation balance. Or the fund received a contribution on 1 July and immediately commenced a pension. Or it completed a partial commutation and immediately withdrew the amount from accumulation on 1 July.

The ATO's view is that this is a matter of documentation as to whether the fund requires an actuarial certificate. If documentation can show that the accumulation account only existed for the split of a second and that no income was earned during that second, then the fund doesn't require an actuarial certificate and can continue to use the segregated method.

If the minutes of a trustee meeting show that the ABP commenced immediately upon receipt of contribution, with the entire balance of the contribution, then that would provide evidence that there was no income while the fund was in accumulation.

Non-Segregated Assets

You will have unsegregated assets for any periods when assets support retirement phase and non-retirement phase liabilities or when the fund is solely in accumulation mode. And you will have unsegregated assets for the entire financial year when the fund has disregarded small fund assets.

You claim ECPI under section 295.390 of ITAA 1997 but need an actuarial certificate if you want to claim ECPI (optional).

The certificate is for a full income year and excludes segregated pension assets.

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SMSF need an ABN

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