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EXEMPT CURRENT PENSION INCOME

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INCLUDES:

- Segregated and unsegregated methods
- Disregarded small fund assets
- Actuarial certificates
- Capital gains and losses

Exempt current pension income (ECPI) is income earned on assets solely supporting retirement phase pensions. To be eligible for ECPI, the retirement phase pension must meet the superannuation pension standards (most notably to pay minimum pensions). In addition, income generated from non-arm's length arrangements cannot be ECPI.

SEGREGATION

There are two methods of determining ECPI – the segregated method and unsegregated method.

Segregated method
Assets supporting the income streams are physically held separately from assets supporting accumulation accounts. The ECPI is identified as income that is derived from the assets that are held separately and wholly supporting income streams. The assessable income of the fund is identified as income that is derived from the assets that are held separately and supporting accumulation accounts. Assets supporting pension accounts are called segregated current pension assets.

Where a fund sells a segregated current pension asset, the capital gains and capital losses from the disposal are disregarded. This results in any unused capital losses not being carried forward to offset capital gains in future years.

The segregated method applies to funds that only have pension accounts, provided funds do not have disregarded small fund assets.

Unsegregated method
Assets supporting the income streams are not distinguished from assets supporting accumulation accounts. An actuarial certificate is required to determine the amount of ECPI based on the average member interests in the retirement phase throughout the year relative to the average total member interests.

This is the most common method of calculating ECPI in SMSFs.

Where an unsegregated fund sells an asset that results in a capital loss, that loss can be carried forward if it is not used to offset a gain in that year. Capital gains are offset against capital losses before the ECPI percentage is applied.

DISREGARDED SMALL FUND ASSETS

Effective 1 July 2017, SMSFs and small APRA funds (SAFs) are prohibited from using the segregated method to calculate ECPI if all of the following apply:

- The fund has a retirement phase pension at any time during the year;
- Any fund member has a total super balance above $1.6 million at the previous 30 June,
  - where the total super balance is the member's balance in all super funds (not just the SMSF or SAF);
- The member with a total super balance above $1.6 million has a retirement phase pension at the previous 30 June,
  - where the retirement phase pension is in any fund not just the SMSF or SAF.

Interestingly, the $1.6 million threshold is defined as $1.6 million, rather than being linked to the total super balance or transfer balance cap amounts. When these thresholds are indexed to $1.7 million, the threshold for disregarded small fund assets will remain at $1.6 million.

A fund that meets the above condition is determined as having disregarded small fund assets, which applies to all assets of the fund for the entire income year. Where funds have disregarded small fund assets they will be required to obtain an actuarial certificate in order to claim ECPI.

Chart 1

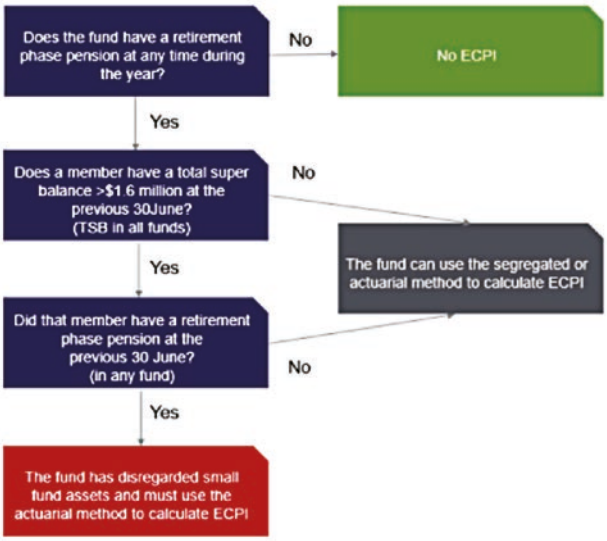


Chart 1 is a decision tree that can be used to determine available ECPI methodologies.

Understanding whether a fund has disregarded small fund assets will be an essential component of completing the 2017/18 SMSF annual returns due by May 2019.

Single fund case studies

Case study 1: As at 30 June 2017, the Mum & Dad SMSF has a $1.5 million accumulation account for mum and a $1.8 million retirement phase pension account for Dad.

- Is the fund paying a retirement phase pension? *Yes.*
- Does a member have a total super balance above $1.6 million at 30 June 2017? *Yes* – Dad has $1.8 million.
- Does that member have a retirement phase pension at 30 June 2017? *Yes.*
  - The fund has disregarded small fund assets and **cannot** use the segregated method.
  - An actuarial certificate is required to determine ECPI.

Case study 2: As at 30 June 2017, the Mum & Dad SMSF has a $1.5 million retirement phase pension account for mum, a $500,000 accumulation account for mum and an $800,000 retirement phase pension account for Dad.

- Is the fund paying a retirement phase pension? *Yes.*
- Does a member have a total superannuation balance above $1.6 million at 30 June 2017? *Yes* – Mum has $2 million.
- Does that member have a retirement phase pension at 30 June 2017? *Yes.*
  - The fund has disregarded small fund assets and **cannot** use the segregated method.
  - An actuarial certificate is required to determine ECPI.

Case study 3: As at 30 June 2017, the Mum & Dad SMSF has a $1.5 million retirement phase pension account for mum and a $1.8 million accumulation account for Dad.

- Is the fund paying a retirement phase pension? *Yes.*
- Does a member have a total super balance above $1.6 million at 30 June 2017? *Yes* – Dad has $1.8 million.
- Does that member have a retirement phase pension at 30 June 2017? *No.*
  - The fund does not have disregarded small fund assets and **can** use the segregated method to calculate ECPI.

Multiple fund case studies

Case study 4: As at 30 June 2017, the Mum & Dad SMSF has a $1.5 million retirement phase pension account for mum and a $1.8 million accumulation account for Dad. Mum also has a $500,000 retirement phase pension in an APRA regulated fund.

- Is the fund paying a retirement phase pension? *Yes.*
- Does a member have a total super balance above $1.6 million at 30 June 2017? *Yes* – Dad has $1.8 million and mum has $2 million.
- Does that member have a retirement phase pension at 30 June 2017? *Yes* – Mum has a retirement phase pension in the APRA fund.
  - The fund has disregarded small fund assets and **cannot** use the segregated method to calculate ECPI.
  - An actuarial certificate is required to determine ECPI.

100% pension assets with disregarded small fund assets

Nonsensically, the disregarded small fund assets definition means that some funds will require an actuarial certificate, even though the fund has 100 per cent of its assets in pension phase.

Case study 5: As at 30 June 2017, the Mum & Dad SMSF has a $700,000 retirement phase pension account for mum and a $700,000 retirement phase pension for Dad. Both pensions commenced with $800,000. However, Dad has a defined benefit pension as a former government employee of $60,000 per annum. The special value of the defined benefit pension is $960,000 ($60,000 x 16). Dad then has a total super balance of $1,660,000.

- Is the fund is paying a retirement phase pension? *Yes.*
- Does a member have a total super balance above $1.6 million at 30 June 2017? *Yes* – Dad has $1.66 million.
- Does that member have a retirement phase pension at 30 June 2017? *Yes* – Dad has two retirement phase pensions.
  - The fund has disregarded small fund assets and **cannot** use the segregated method to calculate ECPI.
  - An actuarial certificate is required to determine ECPI.
  - The actuary will determine that the fund has 100 per cent ECPI.
  - However, without the certificate, the fund is not eligible to claim ECPI.

INVESTMENT CALCULATIONS

There is no prohibition against SMSFs and SAFs maintaining individual investment accounts for members, including maintaining a separate accumulation account and pension accounts for a member. This can be maintained separately, regardless

Continued overleaf

Chart 2

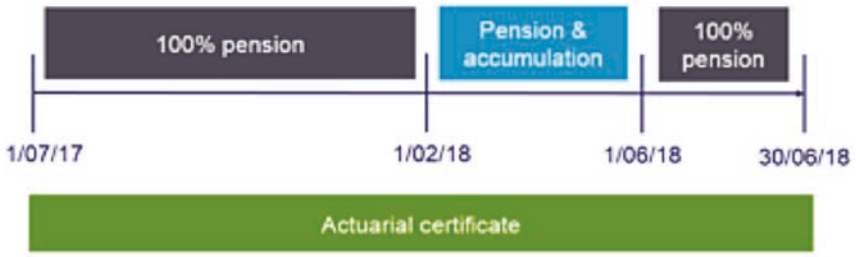
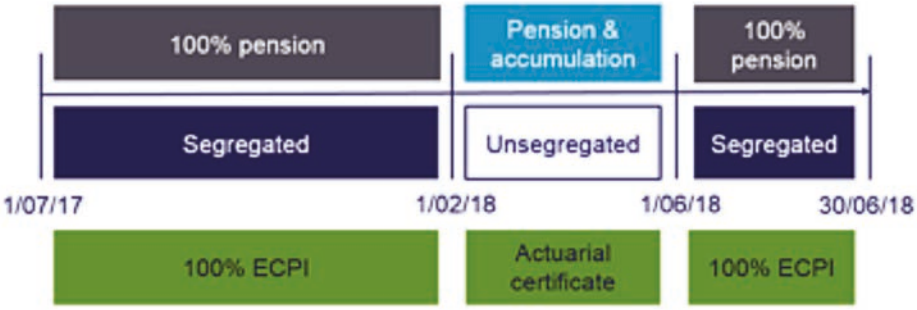


Chart 3



of whether the fund uses the segregated or unsegregated method for calculating its tax liability.

There are two methods of maintaining member account balances:

Member directed investment accounts
The investments for each member (and each member's multiple accounts) are held separately. The investment returns attributed to each member's account directly reflect the earnings for each account.

Pooled investment accounts
The investment decisions for the fund are made by the trustee on behalf of all members. This is the more common method of holding investments in SMSFs.

An SMSF or SAF could invest using individual member accounts and complete its tax on an unsegregated basis. However, trustees in this space should ensure they are fairly apportioning the tax liability across the member accounts.

Where the investments of all members are pooled, it is generally not possible to calculate ECPI based on the segregated method. As the assets and their investment returns cannot be identified as belonging to member 1 or member 2, it is generally not possible to identify the assets and their investment returns that are attributable to retirement phase pension accounts.

ACTUARIAL CERTIFICATES

Small funds also require an actuarial certificate where the fund was not segregated for the full financial year.

Historic view
Historically, if a fund was segregated for part of the year and unsegregated for another part of the year, the actuarial certificate was issued with an ECPI percentage that was applied to the total income of the fund for the whole year. This can be illustrated as set out in Chart 2.

Chart 2 (refer to chart)

- Contribution received 1 February 2018.
- Used to start a pension 1 June 2018.

ATO view
The ATO has stated that from 1 July 2017, if a fund transitions from segregated to unsegregated during the year, each period must be treated separately. All income earned on segregated assets remains fully exempt, but income earned during a period where assets were unsegregated will have the actuarially calculated percentage applied to that income.

Again, understanding this change is an important component of completing the 2017/18 SMSF annual returns due by May 2019.

This can be illustrated as set out in Chart 3.

Chart 3 (refer to chart)

- Contribution received 1 February 2018.
- Used to start a second pension 1 June 2018.

The ATO's view potentially creates significant additional expense for funds that move from segregated to unsegregated during the year. As industry practice was universally not meeting the ATO's expectations, the ATO has stated that it will not be applying compliance resources to 2016/17 and earlier years. However, this is not the case from 1 July 2017.

The most common time this will cause issues for funds is if they are fully in retirement phase but receive a contribution during the year, even if that contribution is then used to commence an additional retirement phase pension. Trustees who expect to be in this situation may consider retaining a small amount in accumulation phase throughout the entire year and therefore be able to use the unsegregated method for the entire financial year (see case study 7).

Multiple unsegregated periods
The ATO has confirmed that if a fund has multiple unsegregated periods, then only one actuarial certificate covering all the periods is required, as set out in Chart 4.

Chart 4 (refer to chart)

- Contribution received 1 August 2017.
- Used to start a second pension 1 December 2017.
- Contribution received 1 June 2018.

CAPITAL GAINS AND LOSSES

Where a fund has segregated current pension assets, any capital gains or losses from the sale of an asset are disregarded. No capital gains tax applies and capital losses cannot be carried forward to offset capital gains in future years.

Where an unsegregated fund sells an asset that results in a capital loss, that loss can be carried forward to offset a future gain if it is not used in the year of sale. Capital gains are offset against capital losses before the ECPI percentage is applied. In an unsegregated fund, the ECPI

Chart 4

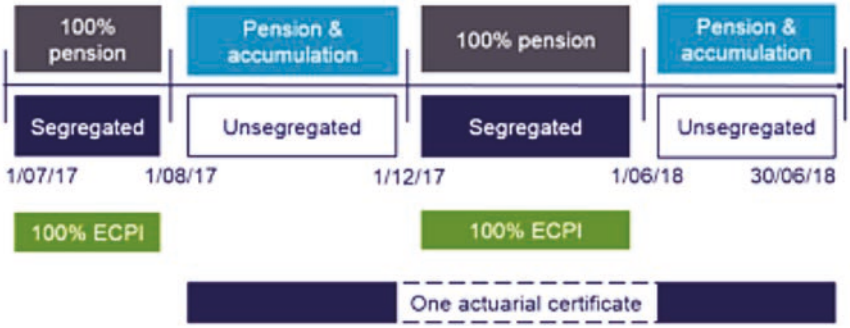
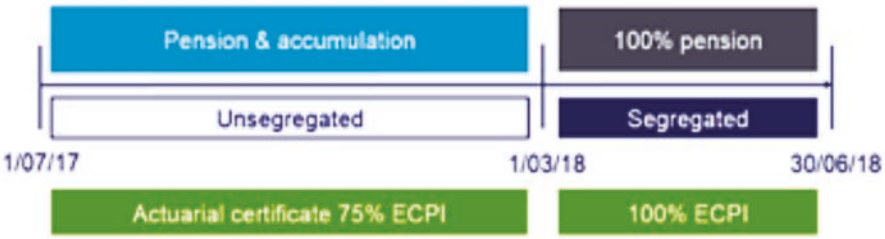


Chart 5



percentage is used to calculate the exempt income on all assets.

Under the methodology required from 1 July 2017, there can be a significant difference in the tax payable by a fund depending upon when an asset is sold.

Case study 6: As at 30 June 2017, the Mum & Dad SMSF has a $500,000 accumulation account for mum and a $1.5 million retirement phase pension account for Dad.

- Mum and Dad have no other super, so the fund does not have disregarded small fund assets.
- On 1 March 2018, mum commenced a pension.
- The actuary determines that the ECPI percentage for the unsegregated period is 75 per cent (Chart 5).

Chart 5 (refer to chart)

- If the fund sells an asset on 1 October 2017 with a discounted capital gain of $100,000, the ECPI will be $75,000 and the assessable income will be $25,000.
- If the fund sells an asset on 1 April 2018 with a discounted capital gain of $100,000, the capital gain will be disregarded and there will be no assessable income.
- If the fund sells an asset on 1 October 2017 with a capital loss of $100,000, the capital loss can be used to offset capital gains in the current year and/or carried forward to future years if not fully used.
- If the fund sells an asset on 1 April 2018 with a capital loss of $100,000, the capital loss will be disregarded and cannot be carried forward.

Case study 7: If we use the same scenario as above, however, mum retains $1,000 in accumulation phase, the fund is able to use the unsegregated method and obtain an actuarial certificate covering the whole of 2017/18.

- The actuary determines that the ECPI for 2017/18 is 82 per cent.
  - If the fund sells an asset on 1 October 2017 or 1 April 2018 with a discounted capital gain of $100,000, the ECPI will be $82,000 and the assessable income will be $18,000.
  - If the fund sells an asset on 1 October 2017 or 1 April 2018 with a capital loss of $100,000, the capital loss can be used to offset capital gains in the current year and/or carried forward to future years if not fully used.
- Retaining a small amount in accumulation phase may also assist if the fund expects to receive contributions in future years.
  - The ECPI percentage is likely to be close to 99 per cent and the cost of obtaining an actuarial certificate and identifying the timing of transactions may be outweighed by the simplicity of applying the ECPI percentage to income from all assets.

MAXIMISING ECPI

The timing of an asset sale is not the only transaction type where timing is important for funds that use the unsegregated method at any time during the year. The calculation of ECPI is determined as outlined in the maximising ECPI chart (see below).

ECPI can be maximised by maximising retirement phase liabilities throughout the year, including by commencing pensions early in the year and by making pension payments and commutations late in the year.

ECPI can also be maximised by minimising non-retirement phase liabilities throughout the year, by making withdrawals from accumulation and transition to retirement pensions (that aren't in retirement phase) early in the year and by making contributions late in the year.

CONCLUSION

It is important to understand the changes that apply to ECPI calculations from 1 July 2017 and how they will impact the completion of the 2017/18 SMSF annual returns. It is also important to note that some clients who only have retirement phase pensions throughout the year may still be required to obtain actuarial certificates.

Julie Steed is Technical Services Manager at IOOF.

Maximising ECPI

Continued overleaf

$$\text{ECPI} = \frac{\text{Average value of retirement phase liabilities}}{\text{Average value of superannuation liabilities}}$$

QUESTIONS

To answer the following questions, go to the Learn tab at moneyandlife.com.au/professionals

1 For a segregated fund to determine ECPI, an actuarial certificate is:

a. Never required.
b. Sometimes required.
c. Always required.
d. Required for each member.

2 Which of the following is not used to determine whether a fund has disregarded small fund assets during a year?

a. A member's total super balance at the previous 30 June.
b. A member's total super balance at 1 July.
c. Whether the fund is paying retirement phase pensions during the year.
d. Whether a member had a retirement phase pension at the previous 30 June.

3 Which of the following statements is true regarding unsegregated funds?

a. Capital gains are disregarded.
b. Capital gains can be carried forward.
c. Capital losses are disregarded.
d. Capital losses can be carried forward.

4 Which of the following is not a strategy for maximising ECPI?

a. Commencing pensions early in the year.
b. Paying pensions early in the year.
c. Paying pensions late in the year.
d. Making contributions late in the year.

5 The Mum & Dad SMSF was 100 per cent in retirement pension phase at 30 June 2018. Mum received an employer contribution on 1 September 2018 and used her full accumulation balance to start a second pension on 1 October 2018. Dad contributed $100,000 on 1 November 2018 and used his full accumulation balance to start a second pension on 15 January 2019. How many actuarial certificates will the fund require for 2018/19 to determine ECPI?

a. None.
b. One.
c. Two.
d. Three.

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