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Pensions & ECPI: Recent Developments and Strategies

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Pensions & ECPI: Recent Developments and Strategies

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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

10 Exempt current pension income

Did the fund pay retirement phase superannuation income stream benefits to one or more members in the income year?

To claim a tax exemption for current pension income, you must pay at least the minimum benefit payment under the law. Record exempt current pension income at Label **A**.

No ☐ Go to Section B: Income.

Yes ☐ Exempt current pension income amount **A** $ ☐☐☐,☐☐☐,☐☐☐·✂

Which method did you use to calculate your exempt current pension income?

Segregated assets method **B** ☐

Unsegregated assets method **C** ☐ Was an actuarial certificate obtained? **D** Yes ☐

Did the fund have any other income that was assessable?

E Yes ☐ Go to Section B: Income.

No ☐ Choosing 'No' means that you do not have any assessable income, including no-TFN quoted contributions. Go to Section C: Deductions and non-deductible expenses. (Do **not** complete Section B: Income.)

Changes to ECPI

Proposed to apply from 1 July 2021

- Two red tape reduction measures proposed in 2019-20 Federal Budget.
- Draft legislation released 21 May 2021 with a consultation period up to 18 June 2021.

- Amendments for both measures to apply in relation to 2021-22 and later income years.

1. Providing choice for trustees calculating exempt current pension income (ECPI).
2. Remove redundant requirement to obtain an actuarial certificate under the proportionate method where all members are solely in retirement phase
   - SMSFs solely in retirement phase with DSFA[1] currently require an actuarial certificate to claim ECPI even though income is 100% exempt.

Providing choice for trustees calculating ECPI

- What's the problem:
  - The ATO released a view on their interpretation of the law in respect to when a fund has segregated assets as part of the 1 July 2017 super reforms.
  - This view was different to industry practice at the time and introduced 'deemed segregation' which requires funds that don't have DSFA and have a period of the year solely in retirement phase, even a day, to use the segregated method to claim ECPI.
  - Funds can end up needing to use both the segregated and proportionate method to claim ECPI in a year.
- The measure will allow trustees a choice on how they calculate ECPI
  - Has come about from the disruption and complexity caused by 'deemed segregation'.

Providing choice for trustees calculating ECPI

- Only applies where:
  - The fund does not have DSFA (a fund with DSFA must use the proportionate method for the entire income year[1])
  - All of the fund's assets are held solely to discharge liabilities for retirement phase interests for part of the income year, **but not the whole income year,** and
  - Retirement phase interests relate to:
    - account based pensions
    - market linked pensions/term allocated pensions
- The choice:
  - Trustee may choose to treat an asset of the fund as being, or not being, a 'segregated current pension asset' provided at the time all superannuation interests in the fund are in retirement phase

1. But refer to second measure for funds that are 100% retirement phase interest for entire income year.

Sugar SMSF at 1 July 2021

Retiree Bruce aged 67

$430,000 in an account-based pension (ABP reversionary to Kerry)

Pension payments paid quarterly

Transfer balance account of $470,000

Retiree Kerry aged 61

$1,140,000 in an account-based pension (ABP reversionary to Bruce)

Pension payments paid quarterly

Transfer balance account of $1,200,000

Cindy aged 25

$80,000 in accumulation

SG contributions received fortnightly

Mike aged 29

$300,000 in accumulation

SG contributions received fortnightly

What happens in 2021-2022

Retiree Bruce aged 67

$430,000 in an ABP (reversionary to Kerry)

Retiree Kerry aged 61

$1,140,000 in an ABP (reversionary to Bruce)

Cindy aged 25

$80,000 in accumulation

Mike aged 29

$300,000 in accumulation

- Kerry passed away 30 July 2021 with a balance of $1,140,000 and her pension automatically reverts to Bruce, the TBA credit will apply to his account on 30 July 2022.
- Cindy and Mike decide they want to leave the SMSF and start their own fund as they have different investment objectives to Bruce, they would like to exit by 1 February 2022.
- Fund earns $78,000 in assessable income.

What happens in 2021-22

Retiree Bruce aged 67

$430,000 in an ABP (reversionary to Kerry)

Retiree Kerry aged 61

$1,140,000 in an ABP (reversionary to Bruce)

Cindy aged 25

$80,000 in accumulation

Mike aged 29

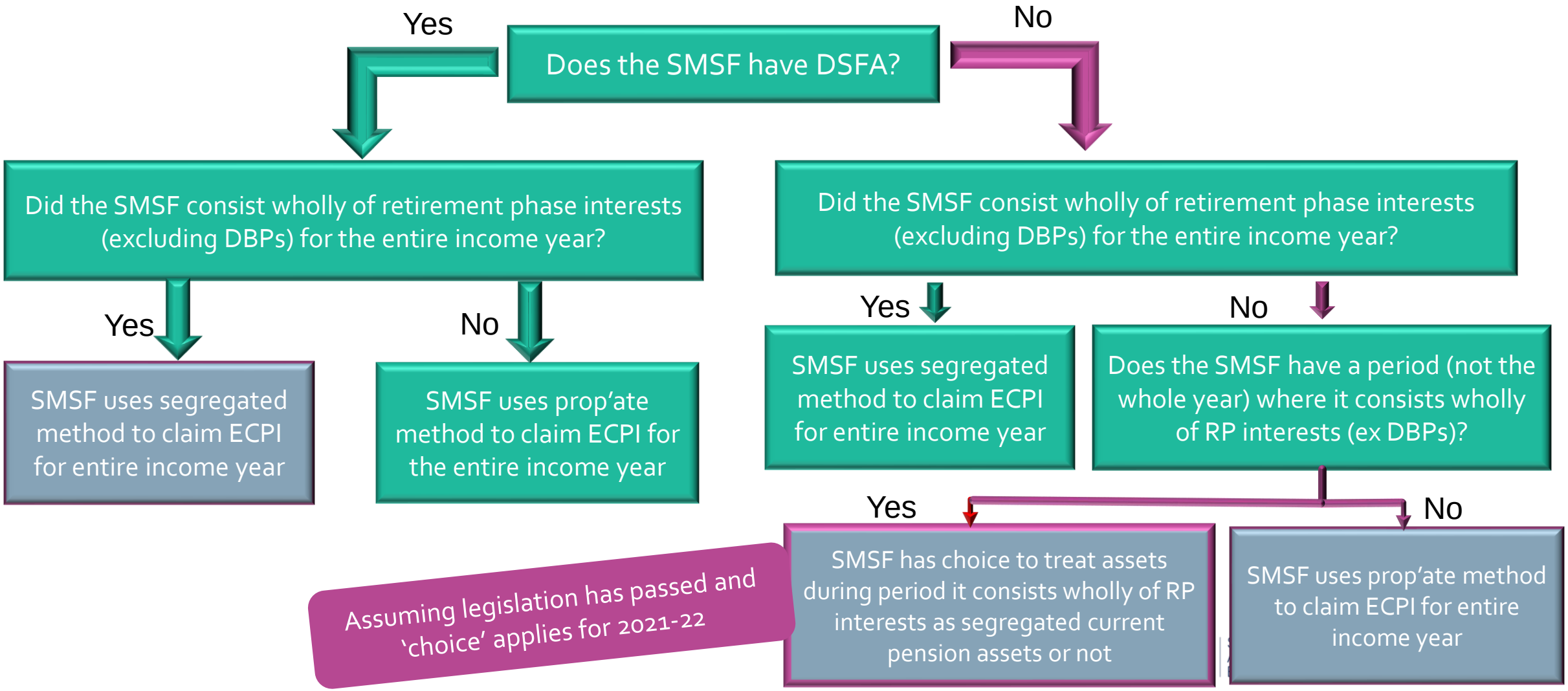
$300,000 in accumulation

Will the SMSF have 'disregarded small fund assets' (DSFA) for 2021-22?

Although general TBC increased to $1.7 million on 1 July 2021 the DSFA threshold remains $1.6 million!

NO
Even though Bruce and Kerry have a retirement phase pension at 30 June 2021, neither have a TSB over $1.6 million

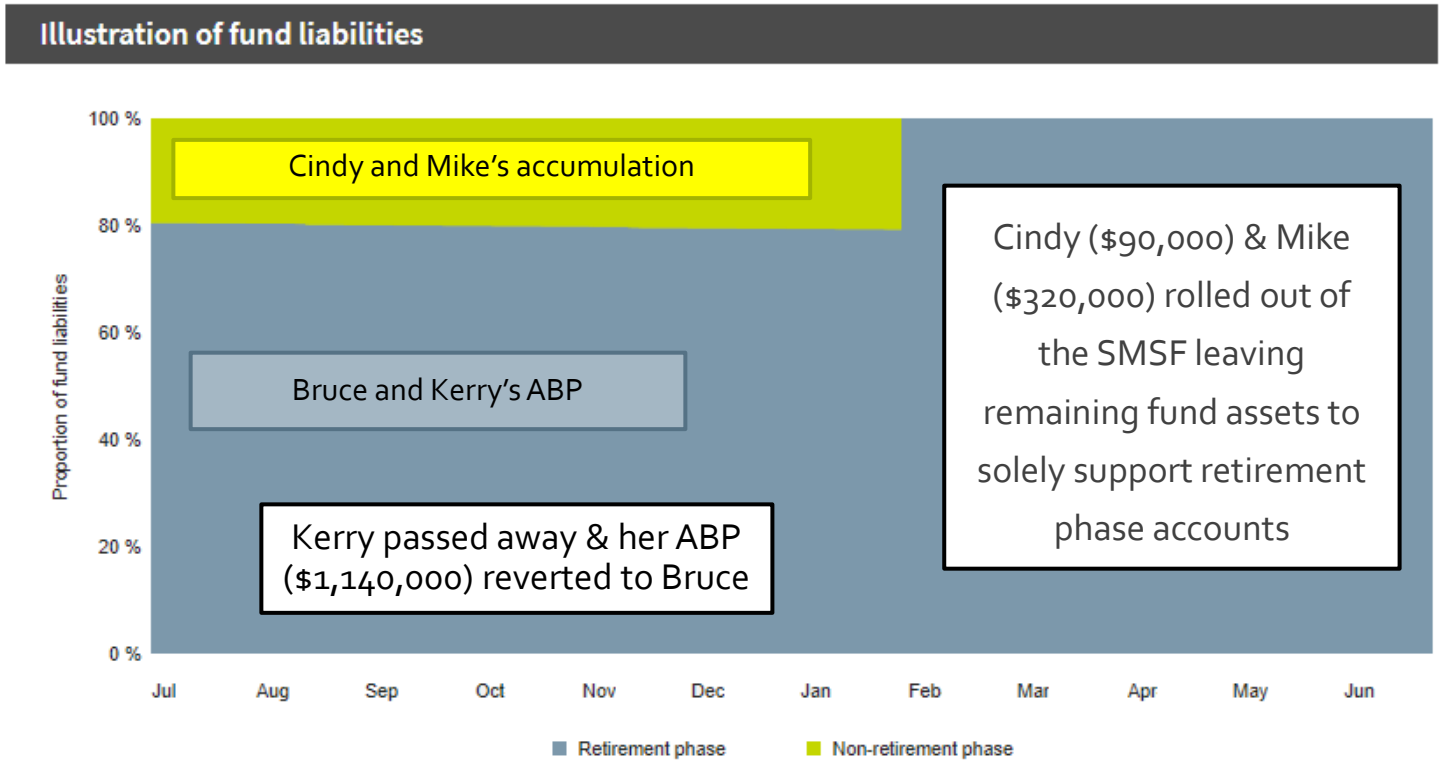
SMSF claiming ECPI from 2021-22 income year



Sugar SMSF claiming ECPI in 2021-22[1]

Fund has choice of how to claim ECPI

- Fund earned income of $78,000 in 2021-22
- Capital gains were realised on or prior to 1 Feb to pay out Cindy & Mike's balances.
- Let's consider two scenarios:
  a) $10,000 net capital gain was realised
  b) $500,000 net capital gain was realised



1. Assuming draft ECPI legislation passed with no changes

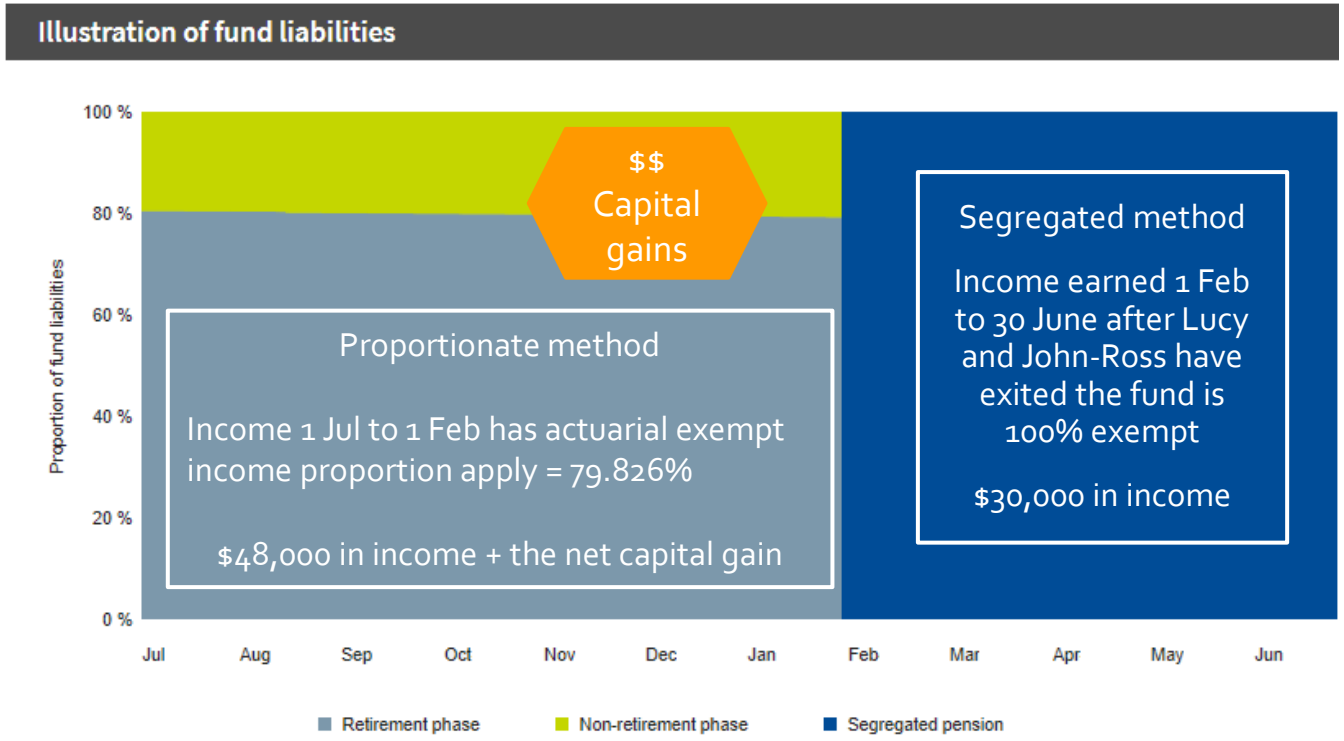
Capital gains and losses

- A fund with some periods in the income year where assets are segregated pension assets, and other periods where is a non-retirement phase balance
  - **With** DSFA: 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: timing is important

- Without DSFA:
  - A capital gain or loss incurred when solely in retirement phase is disregarded
  - When not solely in retirement phase a net gain has actuarial exempt income proportion apply and a net loss is carried forward

Sugar super fund claiming ECPI in 2021-22[1]

Choice made: all assets are segregated current pension assets[2]

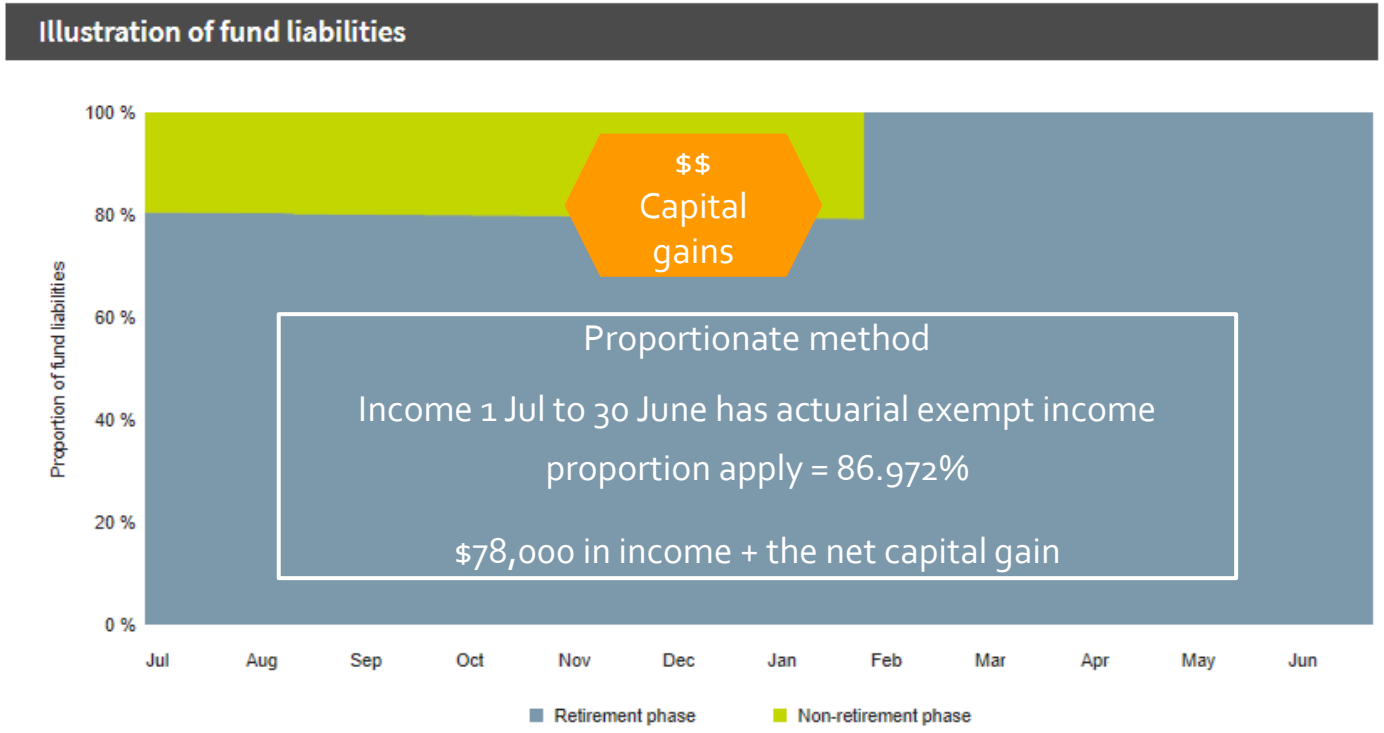


- Actuarial certificate certified 79.826% of unsegregated income will be exempt
- ECPI = proportionate method ECPI + segregated method ECPI
  a) ECPI = 0.79826 x (48,000 + *10,000*) + 30,000 = $76,299
  b) ECPI = 0.79826 x (48,000 + *500,000*) + 30,000 = $467,446

1. Assuming draft ECPI legislation passed with no changes
2. During period SMSF wholly consists of retirement phase pensions

Sugar super fund claiming ECPI in 2021-22[1]

Choice made: all assets are not segregated current pension assets[2]



- Actuarial certificate certified 86.972% of unsegregated income will be exempt
- ECPI = proportionate method
  a) ECPI = = 0.86972 x (78,000 + *10,000*) = $76,535
  b) ECPI = = 0.86972 x (78,000 + *500,000*) = $502,698

1. Assuming draft ECPI legislation passed with no changes
2. During period SMSF wholly consists of retirement phase pensions

Sugar super fund claiming ECPI in 2021-22[1]

Trustee choice: claiming ECPI

Income was earned relatively uniformly over the year and a capital gain was realised in the unsegregated period

a) with no significant lumpy income, the exempt income result is very similar under both methods

[**Note: the choice to treat assets as either segregated or not was made on a collective basis**]

- Only a $236 improvement in ECPI under the proportionate method

a) with a significant amount of income earned at a particular time, the exempt income results is different under each method.

- This is due to the difference in the taxation of the significant capital gain ($500k). Where the trustee elects assets, held during a deemed segregation period, ***not*** to be treated as segregated current pension assets, the proportion of the gain that is exempt is higher
- A $35,252 (+7.5%) improvement in ECPI under the proportionate method.

1. Assuming draft ECPI legislation passed with no changes

Which method is ‘better’ will depend on the exempt income proportions

- An SMSF may find its ECPI claim materially affected by the ability to ‘choose’ whether an asset is treated as a segregated current pension asset or not, if the SMSF
  - has a time in the year where all of the fund is solely in retirement phase, but has a non-retirement phase account at other times
  - doesn’t have DSFA (generally where all members have total super balance under $1.6million)
  - has significant and irregular income or/and capital gains

- Where significant and irregular income or/and capital gains is earned at a time the fund has a non-retirement phase account, then not treating assets as segregated current pension assets will produce higher exempt income
  - Actuarial proportion will include periods where fund is solely in retirement phase, increasing average pension liabilities relative to superannuation liabilities

Which method is 'better' will depend on the exempt income proportions …..continued…..

- Where significant and irregular income or/and capital gains is earned at a time fund is solely in retirement phase, then treating assets held in this period as segregated current pension assets will produce higher exempt income
  - Income in the period fund is solely in retirement phase will be 100% exempt.
  - Note that if a fund realises a net capital loss in a period solely in retirement phase AND the elected to treat the asset as a segregated current pension asset, the capital loss is disregarded and cannot be offset against other assessable capital gains or carried forward.

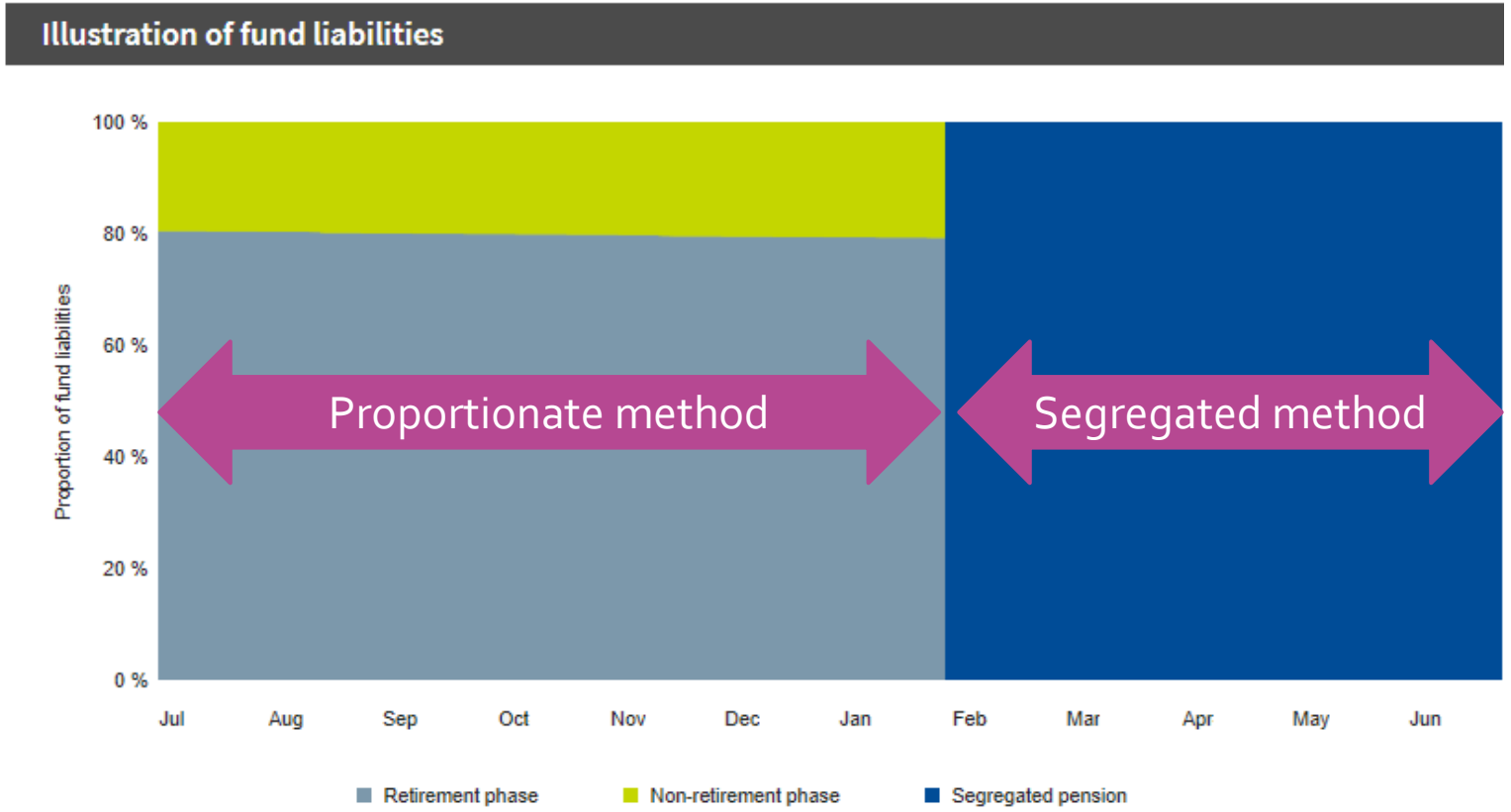
- If significant irregular capital gains or other income is earned at times when solely in retirement phase but also at times when not solely in retirement phase then it will depend on the individual scenario and a comparison will be needed

Which method is 'better' will depend on the exempt income proportions …..continued…..

- If there are no significant irregular capital gains or other income earned in the year then a comparison will be needed but each method is likely to produce similar outcomes.
  - Applying the proportionate method to the entire income year may generally be a simpler approach which would require the trustee to make a choice for assets held during a period wholly consisting of retirement phase interests not to be segregated current pension assets.

Is the choice that simple?

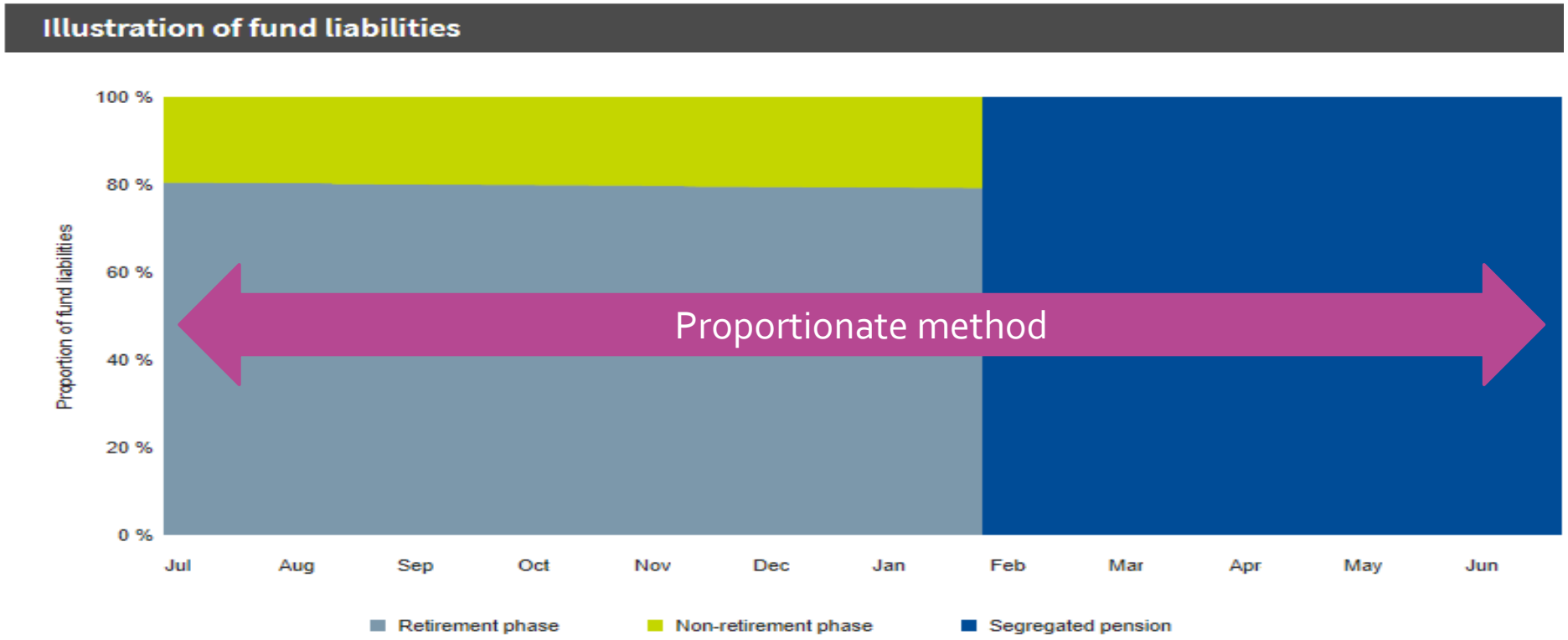
Apply current ECPI approach:



OR...

Is the choice that simple?

Apply simplified (pre 2017-18) ECPI approach:



Is the choice that simple?

Of course not!

- EM (para 1.16) – 'amends the definition of segregated current pension assets in section 295-385 of the by expanding the circumstances when a superannuation trustee can ***choose to not treat <u>an asset</u> of a fund as a segregated current pension asset.'***
- ED – proposed subsection 295-385(9):
  - 'The trustee of a complying superannuation fund may choose to treat ***<u>an asset</u>*** of the fund ***as being, or not being***, a segregated current pension asset of the fund at a particular time in an income year if, at that time, all superannuation interests in the fund are in the retirement phase.'

Remember: this 'choice' is not law yet, it is proposed to apply from the 2021-22 income year.

Also, the format and record keeping requirement, of the 'choice' for a fund asset to be or not to be treated as a 'segregated current pension asset' has not yet been clarified.

When is the choice made?

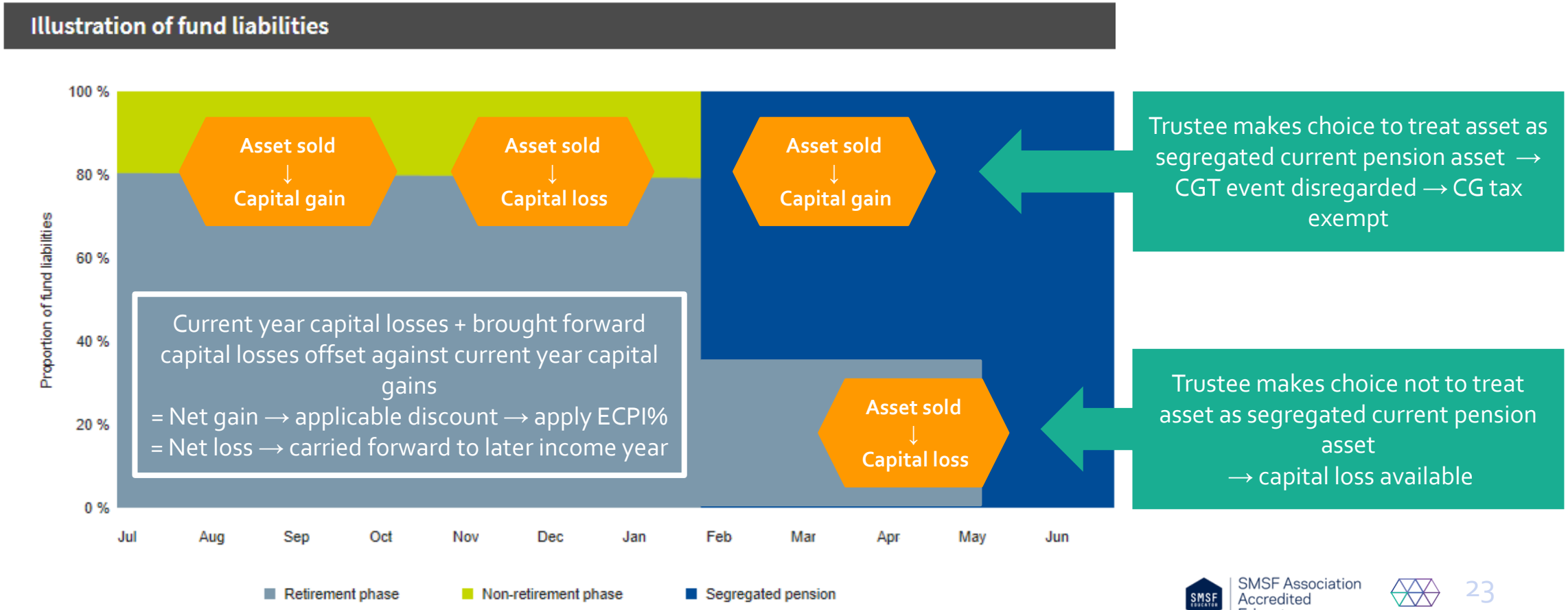
Retrospective choice v prospective choice

- EM (para 1.18) – '….a trustee can decide whether the proportionate method or segregated method is applied to income derived from that asset ***when calculating funds exempt current pension income .'***
- ED – proposed subsection 295-385(9):
  - 'The trustee of a complying superannuation fund may choose to treat an asset of the fund as being, or not being, a segregated current pension asset of the fund ***at a particular time in an income year*** if, at that time, all superannuation interests in the fund are in the retirement phase.'

Opportunity: (assuming the 'choice' can be made retrospectively) the draft legislation appears to provide an opportunity for advice to be provided to trustees on the optimal tax outcome for an SMSF with no DSFA and a period of 'deemed segregation'.

If choice (can be) made retrospectively for an eligible asset

Possible outcome



Summary for funds impacted by 'choice' – have a period of the year solely in retirement phase

- If the fund has DSFA - trustee will have no choice as can't use the segregated method for tax purposes
- 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

Summary for funds impacted by 'choice' – have a period of the year solely in retirement phase

- If the fund does not have DSFA

If proposed legislation is passed: from 2021-22 can choose to treat assets in a deemed period as *not* segregated and so have income, gains and losses treated under the proportionate method

- Must use segregated method in periods where deemed to be segregated on those assets chosen to be segregated, and use proportionate method to claim ECPI on all other assets
- A net capital gain or loss on assets chosen as segregated = disregarded (100% exempt)
- A net capital gain where assets are not segregated will have actuarial exempt income proportion apply, a net capital loss will be carried forward
- General admin expenses relating to segregated assets = non-deductible
- General admin expenses apportioned = use fair and reasonable method based on all fund assets

Changes to ECPI

Proposed to apply from 1 July 2021

- Two red tape reduction measures proposed in 2019-20 Federal Budget.
- Draft legislation released 21 May 2021 with a consultation period up to 18 June 2021.

- Amendments for both measures to apply in relation to 2021-22 and later income years.

1. Providing choice for trustees calculating exempt current pension income (ECPI)
2. Remove redundant requirement to obtain an actuarial certificate under the proportionate method where all members are solely in retirement phase.

Legislation has received royal assent – applies for 2021-22

Sugar super fund claiming ECPI in 2022-23

SMSF wholly consists of retirement phase pensions + DSFA

- What's the problem:
  - Reforms at 1 July 2017 introduced 'disregarded small fund assets' (DSFA) to ensure members impacted by the transfer balance cap could not use partial segregation to still realise capital gains 100% tax free.
  - However, SMSFs solely in retirement phase can have DSFA if member balances grow above $1.6million, and due to DSFA cannot use the segregated method to claim ECPI.
  - Must use the proportionate method to claim ECPI which requires an actuarial certificate even though actuarial exempt income proportion is 100%.
- Legislation will apply from 2021-22:
  - Removes the requirement to obtain an actuarial certificate for calculating ECPI for funds which would have DSFA, but are solely in retirement phase for the entire income year.
  - Permits such funds to use the segregated method to calculate ECPI through excluding from DSFA.

Sugar super fund at 1 July 2022

Retiree Bruce aged 68

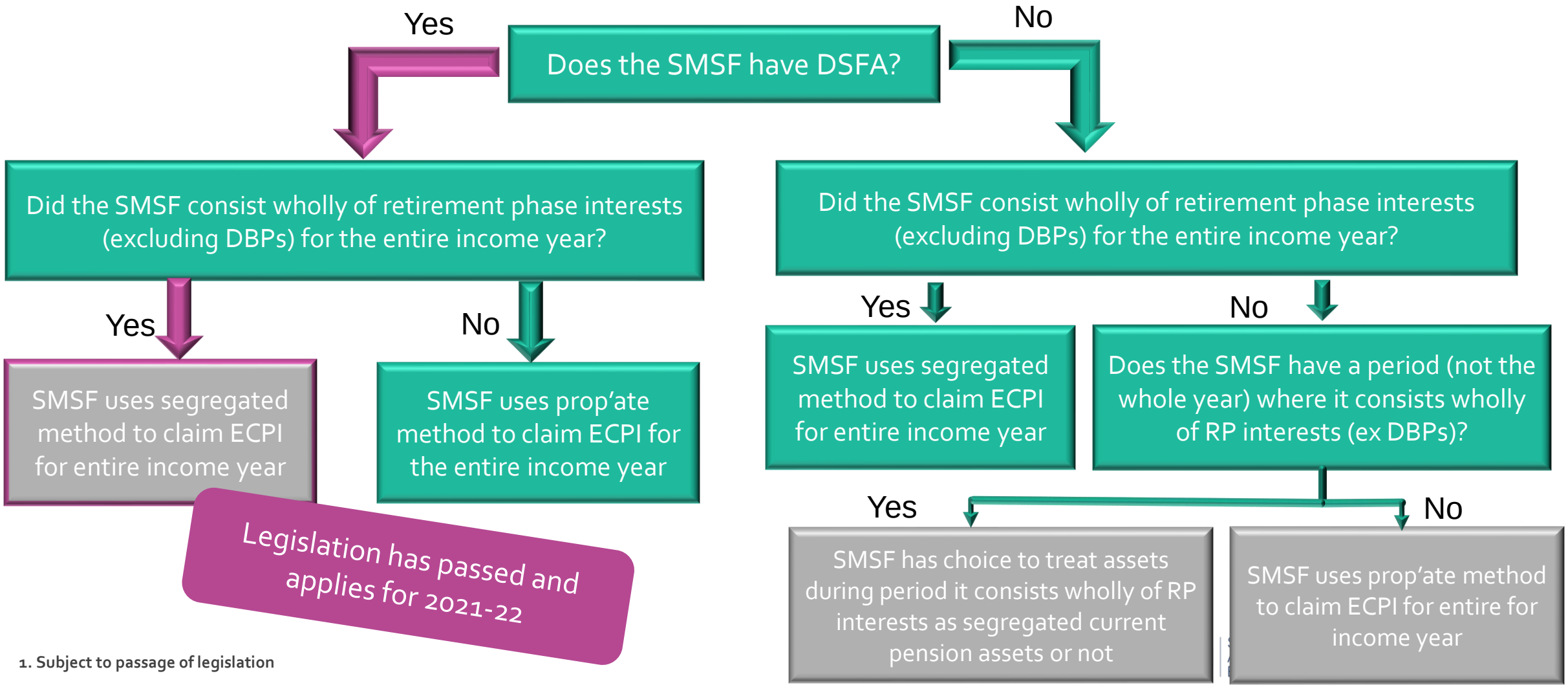
$422,000 in an ABP and $1,215,000 in a reversionary ABP

Pension payments paid quarterly

Transfer balance account (TBA) of $470,000 and personal transfer balance cap (TBC) of $1,671,000

- Some fund assets increased in value over the last year such that at 1 July 2022 Bruce has total super balance of $1,637,000 and has a retirement phase account
- Credit of $1,140,000 will hit Bruce's TBA on 31 July 2022 brining his TBA up to $1,610,000 but as his TBC is now $1,671,000 (due to the $71k proportional increase at 1 July 2021)
- Bruce will not need to commute any of his balance.

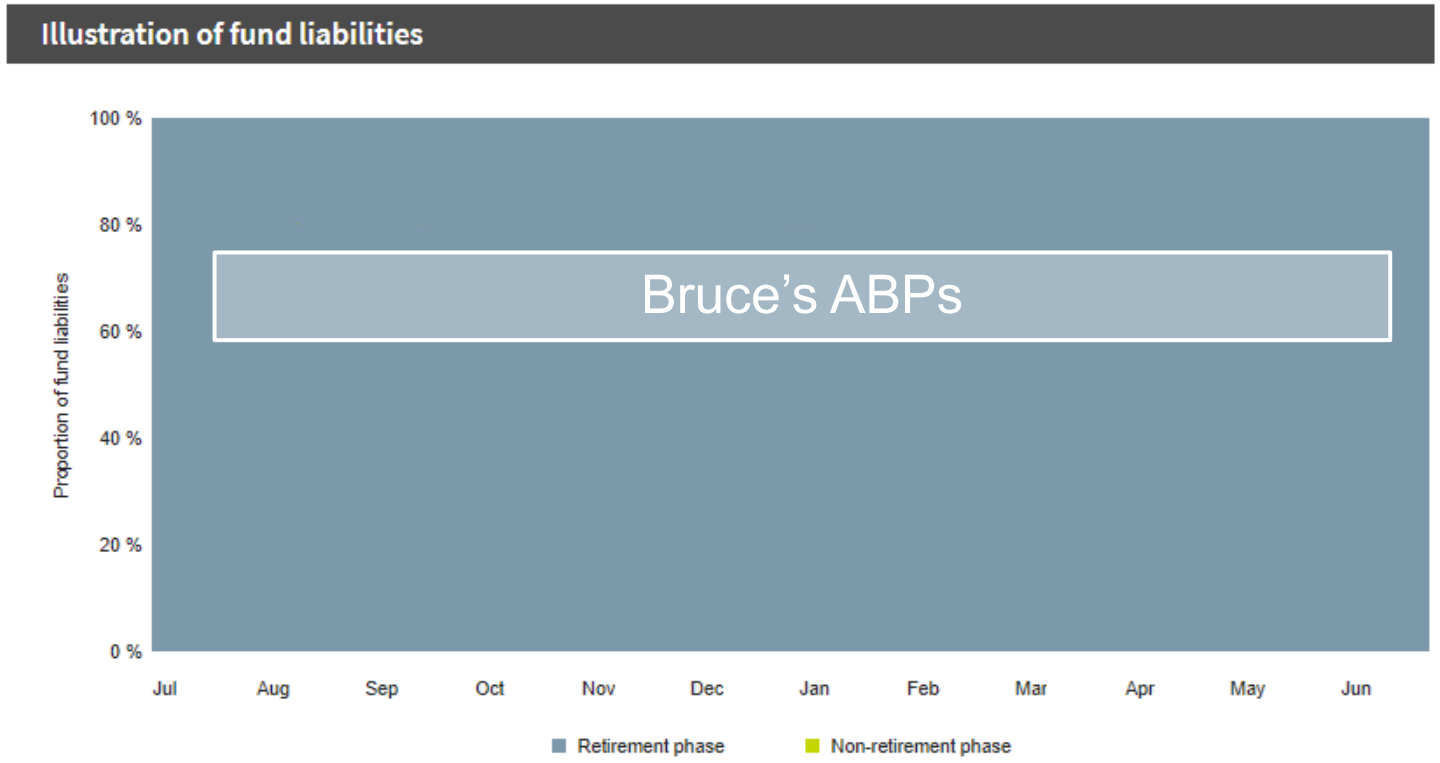
SMSF claiming ECPI from 2021-22 income year[1]



1. Subject to passage of legislation

Sugar super fund claiming ECPI in 2022-23

Legislation passed: no actuarial certificate required



- SMSF would have DSFA, but is solely in retirement phase for all of the 2022-23 income year
- SMSF is not covered by DSFA provision and so can use segregated method
- SMSF claims all income and net capital gains earned in the year as ECPI (100% exempt) using the segregated method → no actuarial certificate required

Some final thoughts

- We estimate only 3%[1] of all SMSFs in 2018-19 claimed ECPI and used both the segregated and proportionate methods due to having deemed or elected segregation
- 'Choice' for ECPI is giving trustees a choice in arrears for assets to be segregated in a 'deemed' period or not purely for tax purposes
- From an ECPI calculation perspective may treat like a hybrid segregation case – 'exclude' segregated assets and so need to know the value of assets chosen as segregated vs not in the deemed period
- Significant work was done by platforms for deemed segregation, but this is different again where a choice is made to segregate some but not all assets in the deemed period
- This has the potential to be very complex. Actuaries or/and platforms may look to modify systems to deal with basic choice scenarios and do more complex scenarios on a case by case basis.

1 - https://www.accurium.com.au/blog/ecpi-draft-legislation-a-closer-look

Want to know more?

If you have and questions please contact us via:

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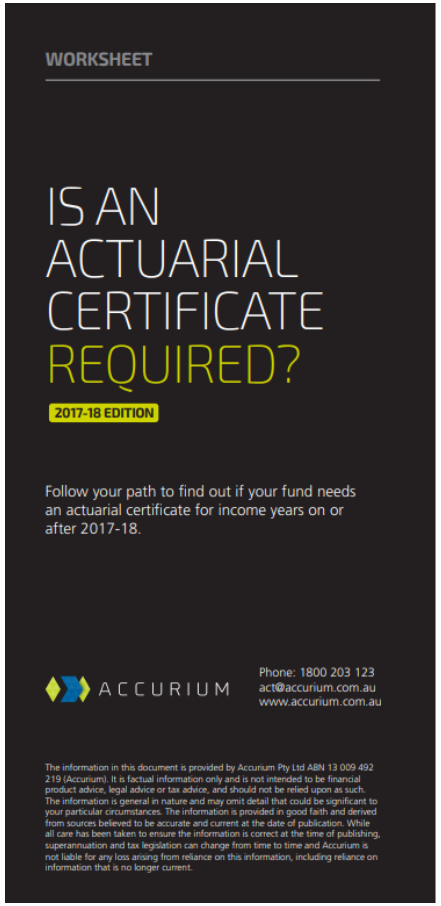
Email: act@accurium.com.au



WORKSHEET

IS AN ACTUARIAL CERTIFICATE REQUIRED?

2017-18 EDITION

Follow your path to find out if your fund needs an actuarial certificate for income years on or after 2017-18.

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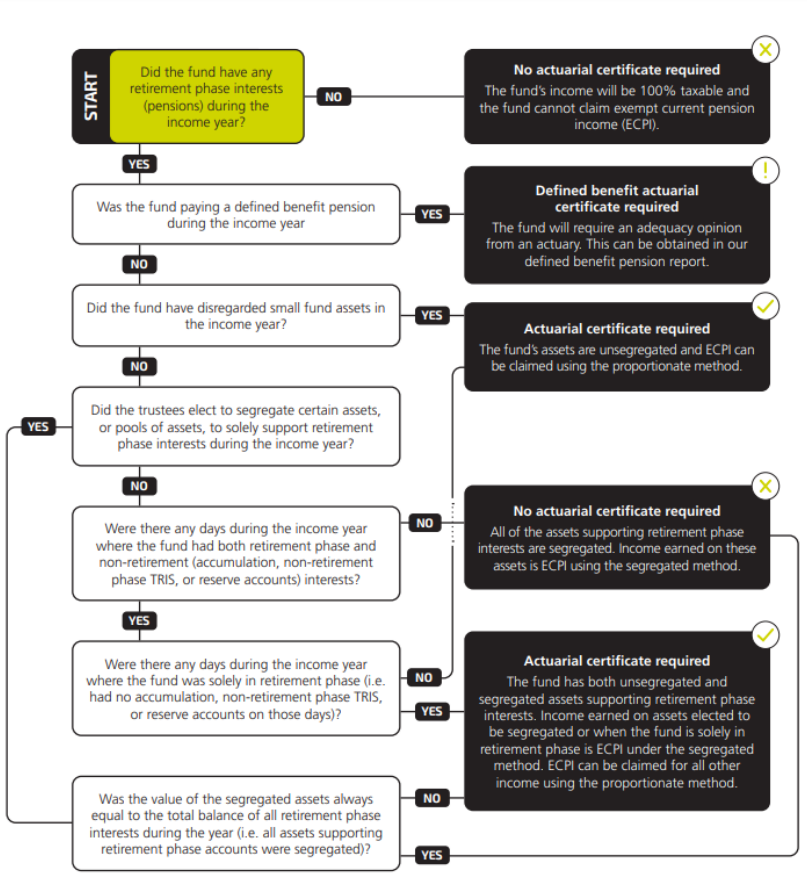

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