**Segregation to get a boost from proposed $1.6m cap**

The Federal Government's proposed $1.6m transfer cap, if passed as law, will most likely see an increasing number of SMSFs using the 'segregated method' for claiming exempt current pension income (ECPI) rather than the more commonly used 'unsegregated method'. This provides an opportunity for Accountants and Advisers to engage with their SMSF client to assist them in understanding the difference between the two methods and maximises the SMSF's claim for ECPI. However, a crucial factor lies in the ability of the software, used to prepare the SMSF's financial statements and SMSF annual return, to correctly apply the segregated method and maximise the claim for ECPI.

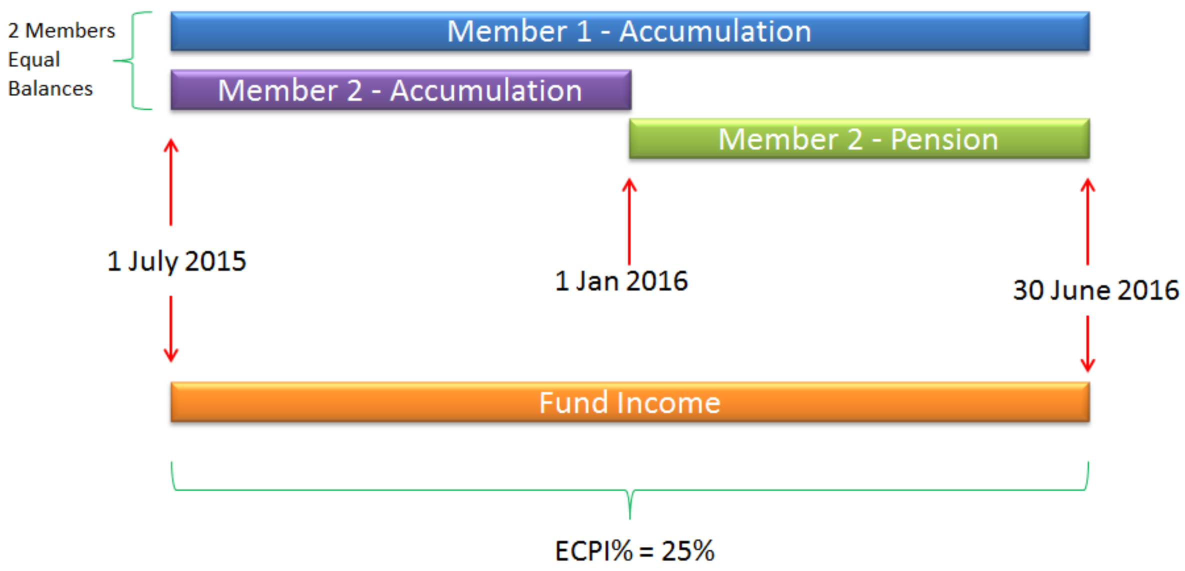
SMSFs with members who currently have more than $1.6m in pension accounts will be required to move the excess (over $1.6m), back to an accumulation account or withdraw from superannuation where the pension balance remains over $1.6m at 30 June 2017, where the proposal becomes law. For affected clients, this can mean that their SMSF is no longer is a 100% tax free position and will need to consider which method, segregated or unsegregated, for the fund to use when claiming ECPI. Depending upon investment transactions for a given income year, a claim for ECPI under the two methods can have very different tax outcomes, particularly where an investment is sold that had a substantial capital gain.

Let's first consider each of the two methods that an SMSF can use to claim ECPI, when it's paying a pension.

***Unsegregated Method***

This method effectively "pools" all the SMSF's assets with the income, from these assets, proportionately allocated between member pension accounts and accumulation accounts. That portion allocated to the pension accounts can be claimed as exempt from the 15% fund income tax. However, the tax rules requires the SMSF to obtain a Tax Certificate from an Actuary, which will advise the percentage of the fund's assessable income that is exempt from the 15% fund income tax. This percentage is then applied to the fund's assessable income, excluding assessable contributions and any fund income classified as 'Non Arm's Length Income' (NALI).

For example, let's consider an SMSF with $1m, split equally between 2 members at the start of the income year, 1 July, 2015. On 1 January, 2016, one of the members, who has retired, commences a pension. Whilst this means that half of the fund is in pension mode from 1 January, 2016, under the unsegregated method, the ECPI percentage issued by the Actuary would be expected to be 25%, as 50% of the fund was in pension mode for half of the income year. This ECPI percentage of 25% is applied for the entire income year, not just the period in which the pension was in place. Consequently, 25% of income earned in the first half of the income year (July to December) will be exempt from fund 15% income tax, even though the fund was not paying a pension during this period. Conversely, only 25% of the fund's income derived during the second half of the income year (January to June) is exempt from fund income tax, even though 50% of the fund is in pension mode.

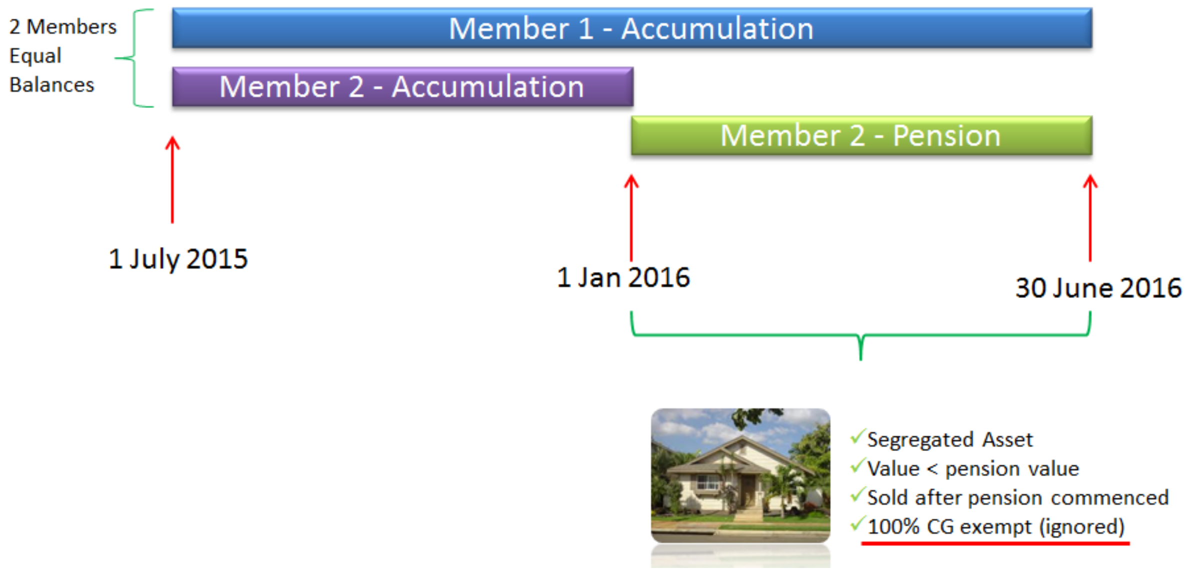



This point is often missed when planning the sale of a fund asset with a significant unrealised gain. The SMSF client is advised that by commencing the pension 50% of the capital gain CG will be exempt, however, if, as is the case in the above example, the unsegregated method is used, then actually only 25% of the CG is exempt. For this scenario, the segregated method should be considered (prospectively) which could result in up to 100% of the CG on the disposal of the asset being exempt from fund income tax. However, as the time the administrator or accountant is attending to preparation of the fund's financial statement is usually well after the date of disposal of the fund asset, the unsegregated basis will apply unless the relevant asset segregation documents are provided by the trustee(s).

***Segregated Method***

This method does not require a certificate from an Actuary, however, does require the SMSF to be able to track income from those assets that have been specifically allocated or segregated to fund pensions. For this method, the value of the fund assets that have been segregated to fund pensions cannot be more than the total value of those pensions. For example, if an SMSF has a total assets value of $1m and the total value of pension accounts is $600k, then a maximum of $600k of fund assets can be allocated or segregated to those pension accounts. The SMSF would then need to be able to track the income from those $600k of segregated assets to claim that income as exempt from fund 15% income tax.

If we take the above unsegregated example, and had, at the time Member 2 commencing the pension on 1 January, 2016, the SMSF trustees segregated fund assets to the value of the pension, then all income, including any capital gains on disposal, would be exempt from fund 15% income tax. So, if one of those segregated assets was a property, upon sale, 100% of the capital gain would be exempt from fund 15% income tax. This compares to the unsegregated method, where only 25% of the gain would have been exempt. Consequently, knowing the future investment plans of SMSF trustees will have a bearing on which method the fund may select to claim ECPI.




***$1.6m cap & ECPI***

From 1 July 2017, the Government is proposing to introduce a $1.6 million transfer balance cap. This cap will limit the total amount of superannuation savings that can be transferred from a concessionally taxed accumulation account, to a tax free retirement account. Subsequent earnings on pension balances will not form part of this cap.

As post 30 June 2017 earnings on a tax free retirement account will not count towards the transfer balance cap, a strategy would be to have high growth assets segregated to the pension accounts to maximise the amount of member benefits that will be in a fund tax free environment, particularly where those high growth assets have a low cost base relative to their market value.

The segregated method allows SMSF Trustees to specifically select assets that will be allocated or segregated to the pension accounts. Compare this to the unsegregated method that treats all assets as one big pool, with income from that pool, including capital gains, being proportionately applied across both pension and accumulation accounts.

SMSF trustees are astutely aware of the effects of the $1.6m propose cap on the fund's claim for ECPI. At a recent SuperConcepts presentation in Brisbane, on the proposed Federal Budget changes to over 130 SMSF trustees, there was a common question being asked, "Can I select which fund assets come under the pension?"

SMSF trustees wanted to ensure that:

- High income producing and growth assets were pension assets so that any increases in asset value would result in a higher pension value, that would not be restricted by the $1.6 cap; and
- Assets with low cost bases and substantial unrealised capital gains would also be segregated to the pension side of the SMSF to maximise the amount of capital gain on disposal that would be exempt from fund 15% income tax.

To achieve these objectives, SMSF trustee would be looking for their accountant or administrator to be proficient with the segregated method for the fund claiming ECPI, rather than simply using the unsegregated method which effectively adopts a proportioning of income methodology.

This led me to the following conclusions:

1. No longer will it be acceptable for SMSF accountants or administrators to simply apply the unsegregated method as a default, simply because it's administratively easier;
2. SMSF Accountants and administrators would need to have a discussion with SMSF trustees about the two methods for the SMSF claiming ECPI and let the SMSF trustees decide which is best to use, taking into consideration any increase cost in adopting the more administratively involved segregated method;
3. There will be a more active role in managing fund assets from an income tax perspective, which would involve the SMSF trustees, accountant or administrator and financial adviser;
4. It would be prudent and helpful for the administration of SMSFs with both pension and accumulation members to be done on a more regular basis than the traditional annual in arrears service delivery.

Further, some important factors for consideration are:

- An SMSF that implements the segregated basis must decide on whether there will be:
  a) two separate bank accounts, that is, one for the pension members and one for the accumulation members; or
  b) only one physical bank account, however, the SMSF administration system used, allows for that one physical bank account to be accounted for as two underlying cash books, again, one for the pension members and one for the accumulation members. This would require on-going monitoring to ensure either cash book account is not overdrawn, whilst the total of the physical bank account has a positive balance. This is another reason why a more regular administration service is warranted where the segregated method is adopted;
- Fund assets must clearly show which side of the fund that they belong to, that is, either the pension side or the accumulation side. This can be done as part of the title registration of the asset or by Trustee Minutes/Resolutions;
- Lumpy assets, for example real property, can be a problem with the segregated method where the value of that one asset is more than the value of the pension accounts. The ATO's view is that you cannot partially segregate an asset to the pension accounts. For example, if an SMSF has a real property asset with a market value of $1m, however, the pension account only totals $700k, the fund cannot segregated on 7/10ths of the property to the pension account. In this situation the SMSF may only have the unsegregated method as the option to claim ECPI;
- The segregated method can only be implemented on a prospective basis. From an Administrator's viewpoint, my concern is that the method used to claim ECPI, in a number of cases, may be from a "looking back" perspective, i.e. retrospectively, for example, where it is discovered that an asset with a significant capital gain was disposed of during the year and the segregated basis provides a more favourable tax result for the fund. Whilst there may be appropriately dated minutes of trustee meetings or resolutions purporting to segregate the

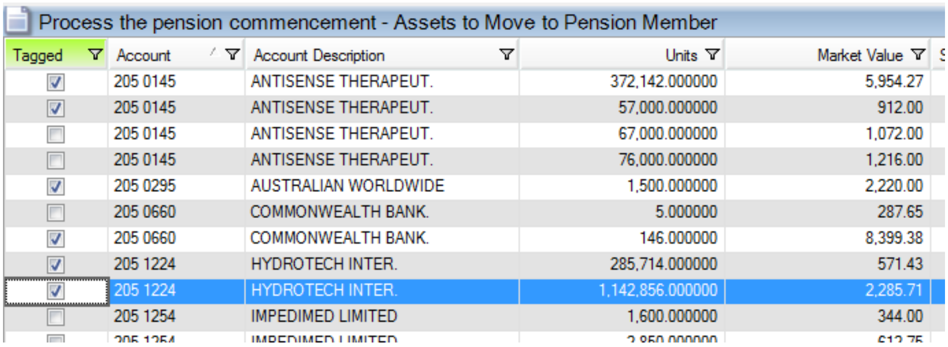
asset as a pension asset prior to its disposal, I am aware of the ATO requesting evidence to substantiate the alleged date of the minute/resolution.

- The choice of which method the SMSF can use to claim ECPI can be changed from year to year. For example in the 2014/15 income year the fund may claim ECPI under the unsegregated basis and then segregate assets for the 2015/16 income year and claim ECPI under the segregated method. However, again, it is important to understand that under the segregated method, the fund must prospectively identify assets which are to be segregated to provide for pensions. This is not something that can be done retrospectively when the fund's annual accounts are being prepared.

***Segregating Fund assets and tracking income***

When using the segregated method, whilst there is no requirement for a Tax Certificate from an Actuary, as the accountant or administrator for the SMSF, you will be required to identify those fund assets that have been segregated as pension assets and track the income from those segregated pension assets to claim as exempt from 15% fund income tax.

This will require the use of specialised SMSF administration software that can implement the segregated method and make the correct claim for ECPI. SuperConcepts' smart SMSF administration and compliance platform, superMate, has strong capability when it comes to an SMSF using the segregated method. When a pension is commenced, superMate's pension wizard will guide the user through the pension set up process, including selecting those fund assets that will be segregated to that member's pension account.



Process the pension commencement - Assets to Move to Pension Member

| Tagged | Account | Account Description | Units | Market Value |
|---|---|---|---|---|
| [x] | 205 0145 | ANTISENSE THERAPEUT. | 372,142.000000 | 5,954.27 |
| [x] | 205 0145 | ANTISENSE THERAPEUT. | 57,000.000000 | 912.00 |
| [ ] | 205 0145 | ANTISENSE THERAPEUT. | 67,000.000000 | 1,072.00 |
| [ ] | 205 0145 | ANTISENSE THERAPEUT. | 76,000.000000 | 1,216.00 |
| [x] | 205 0295 | AUSTRALIAN WORLDWIDE | 1,500.000000 | 2,220.00 |
| [ ] | 205 0660 | COMMONWEALTH BANK. | 5.000000 | 287.65 |
| [x] | 205 0660 | COMMONWEALTH BANK. | 146.000000 | 8,399.38 |
| [x] | 205 1224 | HYDROTECH INTER. | 285,714.000000 | 571.43 |
| [x] | 205 1224 | HYDROTECH INTER. | 1,142,856.000000 | 2,285.71 |
| [ ] | 205 1254 | IMPEDIMED LIMITED | 1,600.000000 | 344.00 |

superMate will then track the income from the segregated assets and claim that income as exempt. A tax reconciliation report is produced to show income from segregated assets that have been claimed as ECPI.

Simon's Pension Fund

## Notes to the Tax Reconciliation Report

**Exempt Pension Income / Deduction Apportionment**

For the year ended 30 June 2015

**EXEMPT CURRENT PENSION INCOME**

The Exempt Current Pension Income is calculated using segregation of assets and income.

The calculation is outlined below using only transactions tagged to segregated pension members:

| | | | |
|---|---|---|---|
| **Gross Interest Income** | | 1,500.00 | |
| **Gross Dividend Income** | | | |
| Imputation Credits | 1,071.43 | | |
| Franked Amounts | 2,500.00 | | |
| Unfranked Amounts | 0.00 | 3,571.00 | |
| **Gross Rental Income** | | 0.00 | |
| **Gross Foreign Income** | | 0.00 | |
| **Gross Trust Distributions** | | 3,200.00 | |
| **Net Capital Gains** | | 0.00 | |
| **Net Other Income** | | 0.00 | |
| **Exempt Current Pension Income** | | | 8,271.00 |

***Getting the claim for ECPI right is good for the fund, you and the ATO***

Given the overall amount of SMSF income being claimed as exempt from fund 15% income tax and the effect of the proposed $1.6m transfer balance cap, if passed as law, reviewing the claim for ECPI will be an obvious audit target for the ATO. Getting the claim for ECPI wrong can be costly, not just for the SMSF having to pay tax and possibly penalties, but also for administrators and accountants who have failed to correctly claim. Again, SMSF clients should be made aware of both methods available for claiming ECPI, rather than the administrator or accountant simply defaulting to the unsegregated method due to this method being perceived as administratively easier. Subsequent discovery by a SMSF client of the alternate segregated method and possible additional tax saving and effect on how much of their overall superannuation balance is in a tax free retirement account may lead to an uncomfortable conversation.

It would be prudent to advise an SMSF trustee of the issues and consequence of both methods and allow them to make a decision as to which method to use and for it to be reviewed annually. However, the option of the segregated method will not be a consideration without an SMSF administration and compliance platform that can handle true segregation. As more and more SMSF trustees ponder the effect of the proposed $1.6m cap, SMSF accountants and administrators need the right tools to be able to implement the strategies to maximise SMSF members' retirement accounts, which includes maximising the claim for ECPI and maximising benefits in tax free retirement accounts.

Want to know more about using the segregation method to claim ECPI using superMate? Existing clients contact us on 1300 359 335, new enquiries call us on 1300 650 135