Podcast Show Transcript

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Topic:	ATO changes to determining a fund's tax exemption
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Aaron Dunn: You're listening to the SMSF Podcast Show. This is episode 19.

Recording: Welcome to the SMSF Academy Podcast. The show designed to help professionals stay ahead of the curve. Now here's your host, the man that's in the know and shows you how a SMSF is done right, Aaron Dunn.

Aaron Dunn: Hey there Aaron Dunn here and thanks again for joining us for The SMSF Academy Podcast. It's great to get this podcast up and running again and the feedback that we've had in our first two weeks is certainly keeping me motivate to keep going on. We do have so much content to be going through and I look forward to continuing to share with you many of the strategies and issues as they come to hand. Most importantly, our commitment to helping you stay ahead of the curve.

One of the more controversial issues that we've seen in recent times is around the ATO's updated view in calculating exempt current pension income. This is somewhat different to the way in which we as an industry have understood how exempt current pension income has been calculated. In particular, where throughout the year the assets have been segregated for part of their income year. Now of course we have the different methodologies that we use whether the fund has assets that are segregated. We've specifically set aside assets in order to claim income tax exemption or where we have segregation by default. That is all of the fund's assets are there to solely discharge the pension liabilities that exist in the fund. We may have a mum and dad clients for example and the combination of those two are effectively in a 100% pension fund. The ATO in those circumstances considers that fund to be a segregated fund.

There are circumstances where from the first of July 2017, a fund will be unable to claim the segregated method as a result of the superannuation reforms. We can't claim exempt current pension income under section 295-385 of the ITAA 1997 where the member has a total superannuation balance over $1.6 million immediately before the start of that relevant income year. We're looking at the balance at 30 June 2017; that member was receiving an income stream from any source; it could be the SMSF or it could be from another superannuation provider. That amount gets captured under the definition of disregarded small fund assets in section 295-387. There are circumstances where through the prohibition of applying segregation for income tax purposes that a fund may end up having to get an actuarial tax certificate even though it is 100% in pension phase. I've touched on this previously as an outcome that is nonsense. We were hoping that the ATO in conjunction with Treasury would look to make some amendments to not require a certificate in this process but clearly we haven't seen anything come to fruition or it's fallen on deaf ears.

What is the most important piece to note across this change is as I touched on earlier around the segregation for part of an income year because where for example we had a fund that was 100% pension phase at the start of the income year and the individual made or any individual made a contribution throughout that year we ordinarily look to apply or determine income tax exemption under the proportionate method. The actuary would determine the level of income based upon a weighting of opening and closing balances plus the inflows and outflows throughout that year to determine the percentage in which the fund would claim exempt current pension income (ECPI). If that contribution was made in March, then it's going to be factoring in the timing of that contribution for the weighted calculation of the fund's tax exemption calculation.

However, the ATO has now taken an alternate view to determining income tax exemption. This goes to the very definition of section 295-385 where we have income from assets set aside to meet the current pension liabilities. Subsection (3) here talks about assets of a complying fund are segregated current pension assets at a time if the assets are invested, held in reserve or otherwise dealt with **at that time,** and that's the important piece, solely to enable the fund to discharge all or part of its liabilities contingent or not in respect of retirement phase superannuation income stream benefits **at that time**.

The concept of at that time is a really important one now because what the ATO is saying here is if the assets of your fund are segregated for only part of an income year and you wish to claim that exempt current pension income for the remaining period of the year in which the assets of the fund are unsegregated, there is going to be a requirement to obtain an actuary certificate for that period in which the fund's assets are unsegregated.

Rather than looking at this in its entirety over the year in an unsegregated environment, we now need to create different accounting periods - from the start of the year through to the time that say a contribution was made, we are simply applying that under the segregated method. Then we have to create a separate accounting period from the time that the contribution was made through to the end of the financial year, and at that point we are then calculating the exempt current pension income through the actuary certificate to determine a percentage. That is a fundamental shift in how we have ordinarily understood those rules to work.

With this change, what the ATO is saying here is that in instances where all of the fund's assets are held solely to meet the superannuation income stream liabilities, that is, 100% of the fund's assets are used to support those pension liabilities, the ATO says that it is all of the fund's assets in these circumstances that are deemed to be segregated at that point in time. This means that any portion of any income year where a fund's assets are held solely to meet those income stream liabilities, the trustee is required to calculate its exempt current pension income for that portion of the year using the segregated method. We don't need to therefore obtain an actuary certificate for that period of time in which we're claiming ECPI.

However, for the portion of the income year that the fund is not 100% pension phase, for example the member has a mix of pensions and accumulation phase interests for a part of that year the SMSF assets are no longer deemed to be segregated. Therefore, the fund is going to be required to use the proportionate method under section 295-390 to determine the exempt current pension income for that period. That is, the trustee's going to be required to get an actuarial certificate if they wish to claim the exempt current pension income in relation to income received during that period. We have the opportunity there if we need to, subject the level of exemption being calculated to obtain a certificate or not – that is, assess whether the benefit outweighs the cost of the certificate. If not, the we don't actually need to obtain a certificate. The ATO has already indicated that in past speeches that they've given to the profession on this topic. The actuary here will calculate the proportion of the fund's income that is supporting those pensions during that part of the year when the fund's assets were not segregated.

Again, we're having to establish a separate period here from the point in time in which there was an accumulation and pension interest. That means we will potentially have multiple accounting periods throughout that particular financial year. That is where this fundamental change occurs against what the industry has adopted as standard practice. This is clearly something different and will require both the actuaries and the software providers to have to update systems and processes around the practice that has been adopted within the industry for many years.

The ATO has recognised this issue and it's said that in instances where the approach or practice is not consistent with their position, then what they're going to ensure is that we will have for the '16-'17 year and prior years to undertake either the standard practice or alternatively adopt the ATO's current practice. There is some scope in there to look at the different circumstances that may present a better calculation for the year based upon these two different scenarios.

What the ATO has said here is that they understand in some cases a SMSF has been 100% pension phase for part of an income year, but actuarial certificates have been obtained by the trustees on the basis of the fund's assets are unsegregated for the entire year and the percentage that has been calculated by the actuaries has been applied for the entire income year. Now considering what the Commissioner deems to be a low risk on this issue regarding prior years, they don't intend on specifically reviewing the ECPI calculations for the '16-'17 year and prior years regarding calculations that have been made on that basis.

The ATO here has suggested that their compliance approach to this issue does not affect their position regarding the current operation of the law, and they'll maintain this position if formally requested throughout a process of obtaining specialist advice or rulings in respect to that 2016-17 year and prior.

That is an important shift that we will need to undertake and not only look to adopt where possible for the '16-'17 year but if you are unable to do so as part of the actuarial process then remember that the ATO will give us a concession for the lodgement of the '16-'17 return.

However, from '17-'18 we need to look at the new calculation where we have a part year that was unsegregated and switched to segregated or vice versa. We need to look at and identify those specific periods, which in many instances could be quite significant because we could have multiple periods where it may be part pension, full pension, back to part pension, full pension, et cetera, et cetera. There will be a lot of water to go under the bridge in respect to this issue, in particular around how the software providers and the actuaries (who aren't too happy) in respect to this matter and are looking to further pursue this as an issue.

I know the professional bodies, in particular the SMSF Association and the Actuaries Institute of Australia have been lobbying pretty hard around impact of this revised position. We do just need to wait and see if there's any further action for the '17-'18 year going forward, but the ATO at this stage when we look at the definition around section 295-385, appears quite clear that we're looking at the position **at that point in time**, which does make it even more interesting now because we're going to have to factor in those different accounting periods throughout the income year.

In terms of what we might need to be contemplating in the future around this shift in view, we have as I said a range of funds that will be ineligible to be able to claim the exemption under the segregated method anyway by virtue of the disregarded small fund's asset definition - they're not going to be able to claim tax exemption under the segregated method, but there is going to be a significant number of funds that are still eligible to segregate, in particular when you think about the number of funds that have members under the $1.6m and are 100% pension phase. There are a couple of things that we need to contemplate if we have periods of time where maybe through a contribution we end up with a period or a proportion of time where we may have an accumulation benefit.

A couple of things we could look at here (1), let's say a contribution comes in as part of the re-contribution, we may look to convert that to pension immediately. If we do it on the same day as the contribution went back into the fund then in reality we never had a day in which the fund was in accumulation phase. On that basis we could argue that it continued to be segregated throughout the entire year, because we start that pension on the same day that the contribution came in. Of course, we're going to have to overlay that with the events based reporting as well, but that is one way in which we could potentially get around the issue.

The other way is looking back at Tax Determination 2014/7, which looked at this issue around segregation initially with bank accounts. The determination talks about this notion of creating sub-accounts around the fund's bank account to be able to receive say a contribution. This sub-account notion is very common within APRA funds. We may have something like the BT super platform. There is really only one bank account that deals with all cash, but each member account has a sub-account of that or a branch of the main bank account in which we can account for that members interest that sits inside that bank account. That sub-account notion can also apply to SMSFs.

What that may enable us to do is to effectively separate or have separation across the assets that may be sitting inside the member's accumulation phase interest against what they may have in retirement phase. Therefore, if we have that sub-account, we would get no tax exemption around the amounts that are sitting inside the accumulation interest but we would get full tax exemption on the assets that are supporting the pension interest or the superannuation income stream. There may be an opportunity there to look at the sub-account more prudently - I think more simply it might be better to just look at the timing in respect to those income streams or converting what was a contribution into an income stream.

It is a highly controversial and topical issue at the moment, this decision around exempt current pension income like I've said the ATO has given us a period of grace for the current income year. However, as I've touched on for the '17-'18 year income year and onwards, the ATO has made it clear that they expect trustees to calculate exempt current pension income and calculate actuarial tax certificates on the basis that I've talked about in today's podcast. That is where the fund's assets are unsegregated for part of that income year, the trustee is going to be required to obtain an actuary's certificate that pertains to that part of the income year if we wish to claim the exempt current pension income for that income received during that period. It is going to mean we're going to have to focus on how we are accounting for those different periods potentially looking at valuations to determining opening and closing balances throughout that period if we think about what the actuaries need to determine not only the opening and closing balances but those inflows and outflows to determine the tax exemption that is going to come back and be applied for that unsegregated period.

If you got any questions around this topic you can reach out to me at info@thesmfsacademy.com.au, through our various social media channels or simply comment off the back of this podcast as well. Thank you for your time today. Hopefully, you've got a great deal of information around this pretty fundamental shift in how we're claiming income tax exemption not only for the current year but into the future.

There are a couple of opportunities that you could be looking at in particular around this year where it may provide a better result using one approach rather than the other. In particular, where we think about capital gains, and capital losses - whether they're going to be disregarded under the section 118-320 or whether we may be able to absorb or utilise those capital gains or losses under the method statement in section 102.5, of Income Tax Assessment Act. Plenty to think about!

I look forward to you joining me for our next podcast. Take care and I'll speak soon.

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