SMSF PENSIONS AND SEGREGATED ASSETS

The ATO has announced its intention to provide closer scrutiny over SMSFs paying pensions. This article takes a closer look at income and capital gains generated by assets supporting pensions.

One area of common misunderstanding relates to the calculation of the tax free portion of income and capital gains generated by assets supporting pensions. In its draft determination, TD 2013/D7, the ATO has provided some clearer guidance for SMSF trustees paying income streams from segregated assets.

Released by the ATO on 7 August 2013, Draft Taxation Determination TD 2013/D7, titled *Income tax: in what circumstances is an asset of a complying superannuation fund a segregated current pension asset under section 295-385 of the Income Tax Assessment Act 1997?*, deals with the segregation of assets which support the income streams paid by superannuation funds.

Although in draft form, TD 2013/7 has generated a range of reactions from practitioners in regards to the segregating of assets to meet pension liabilities - particularly the segregation of a **part** of an asset.

The ATO's position, as outlined in the draft determination, should not have come as a significant surprise, given that the matter was discussed at the March 2010 meeting of the NTLG Superannuation Technical Sub-group. At that meeting, the question was put regarding a fund owning property and whether it was possible to treat a 50% portion of that property as a segregated current pension asset for the purposes of s 295-385 of the ITAA 1997.

In answer to the question, the ATO provided a preliminary response that it did not consider part of a property, or cash at bank recorded as part for accumulation and part supporting a pension, would be allowed to form part of the segregated assets supporting a pension. The main reason provided by the ATO was that s 295-385(3) of the ITAA 1997 required that the asset be held 'solely' to enable the fund to discharge its pension liabilities.

At the NTLG meeting of March 2010, it was stated that a range of interpretations were being applied to the issue of segregating portions of assets, and it appears from some of the reactions to TD 2013/7, that differing interpretations have continued to exist.

Background

The authority for trustees to claim a deduction for Exempt Current Pension Income (ECPI) stems from two particular sections of ITAA 1997, being:

- s 295-385 for segregated assets; or
- s 295-390 for unsegregated assets.

Section 295-385 provides an exemption from tax for the income from assets set aside (segregated) to meet current pension liabilities. In other words, the income and realised capital gains generated from assets segregated to the pension account or accounts will be tax free.

Under section 295-390, a portion of the income and realised capital gains will be tax free. The percentage of the overall fund income which is tax free will generally be calculated by an actuary.

What is Segregation?

In the tax and superannuation context, segregation could be explained as the isolation of different assets, some to provide for the payment of income streams and others to support the accumulation accounts of the members.

Generally, segregation of assets between pension and accumulation accounts in a SMSF is more labour intensive, as the transactions from the assets segregated to support the pension must be kept separate from transactions relating to the accumulation assets. Without requiring the calculation of an actuary to determine the amount of tax free income, the trustee of the SMSF claims a deduction for ECPI, in the annual return of the SMSF, for the total amount of income and gains derived from the segregated pension assets.

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Alternatively, an SMSF which pays a pension from unsegregated assets portions the income generated from all assets across the pension and accumulation accounts of the members. The trustee then obtains from an actuary the percentage of income which will be treated as tax free.

Note that the assets of SMSFs which are solely paying pensions for the whole year (i.e. with no contributions or accumulation balance) are deemed to be segregated.

ATO's view

The ATO's interpretation of the legislation revolves around the reference made previously to the word 'solely', and the test which the ATO applies throughout TD 2013/7 deals with what it refers to as the 'relevant sole purpose'.

Clearly stated in TD 2013/D7, the ATO's view is that, for all types of assets able to be segregated:

- *an asset cannot be partly invested … for the relevant sole purpose and partly for another purpose; and*
- *part of an asset cannot be invested … for the relevant sole purpose, and another part of the asset invested … for another purpose.*

Contrary view

Mentioned previously, a range of procedures in regards to segregation of assets has evolved over the years in the absence of specific direction. That has led to a number of views contrary to the ATO's position on the word 'solely', which include suggestions that:

- a portion of an asset, such as property, **can** be solely segregated to a pension account (or accounts) with the remaining portion segregated to the accumulation account(s). Receipts and expenses generated from the investment could be allocated accordingly; and
- one bank account **can** be held, with internal segregation in the books of the SMSF between the pension account(s) and the accumulation account(s), without breaching the solely segregated requirement.

Other issues

Other aspects covered in TD 2013/D7 include instances where receipts or outgoings received by the trustee require apportionment between segregated accounts, the scenario where more than one member of a SMSF is in receipt of a pension, and the segregation of assets shortly before disposal. In each of those instances, the ATO's position is:

- receipts or outgoings (i.e. tax refund or payment) will, through necessity, be paid to or from a single bank account - the trustee will need to transfer a portion of the amount from one account to another to maintain segregation;
- some essential incidental expenses relevant to the operation of the fund, rather than to particular segregated assets, may be paid from a segregated bank account without causing 'relevant sole purpose' concerns;
- assets do not need to be segregated on a 'per pension' basis - the segregation may be on a 'total pension' basis - i.e. two separate 'pools' of assets can be maintained, one for multiple pensions and one for multiple accumulation accounts; and
- if a capital gain is claimed as exempt income, from the sale of an asset shortly after it was segregated as a pension asset, the ATO will consider applying the anti-avoidance provisions of Part IVA.

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Regarding the last point, the ATO referred in TD 2013/7 to the Explanatory Memorandum which introduced the predecessor to s 295-385 of the ITAA 1997, which stated that the segregation of current assets to avoid capital gains tax would be contrary to the intention of that section.

However, that does not mean that all asset sales after a pension is commenced, and/or assets segregated to support a pension, will be deemed to represent avoidance. The ATO stated that the circumstances behind the sale after segregation of the asset would be considered in determining whether avoidance had occurred, as shown in the following examples.

Example 1

Jenny, the sole member of her SMSF, retires from employment and decides to commence drawing a pension from her SMSF. However, the SMSF has a significant asset which has risen appreciably in value over the years, but provides minimal income. As cash flow is required to provide for the payment of the income stream to Jenny, the trustee resolved to sell the significant asset.

Whether the sale occurred before or after the commencement of the income stream should have no bearing on the consideration of avoidance. Additionally, the ongoing nature of the pension will provide definite indication that the sale of the asset, whilst the fund was in pension phase, was not for the purpose of avoiding capital gains tax.

Example 2

Ian, the sole member of his SMSF, commences a transition to retirement income stream (TRIS) from his SMSF.

Once the pension has commenced, Ian arranges for the sale of a property held in the SMSF, at a significant capital gain. Following settlement, Ian commutes the TRIS back to accumulation.

In Ian's case, the primary purpose for the commencement of the TRIS would appear to have been the avoidance of the capital gains tax which would otherwise have applied on the sale. Therefore, Ian's SMSF could potentially have the anti-avoidance provisions of Part IVA applied by the ATO.

Conclusion

The ATO proposes that the Determination, when finalised, will apply from 1 July 2014. For practitioners who have SMSF client funds with partial asset segregation, including bank accounts, a greater amount of work will be required to maintain segregation. Alternatively, they may wish to remove the segregation and have the SMSF obtain an annual actuarial certificate to determine the ECPI.

Given the ATO announcement that it will be increasing surveillance of SMSFs paying pensions, including the calculation of ECPI deductions and the basis for such deductions, trustees and advisers should consider the structure under which SMSFs are applying assets to support income streams and whether any of the supporting assets are apportioned between income streams and accumulation.

Finally, the commencement of short-term pensions to ‘cover’ asset sales is likely to result in ATO scrutiny and, possibly, imposition of tax.

More information

Should you have any queries or require more information, please contact the team at Topdocs on 1300 659 242.

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