WealthtracSMSF

Apportioning SMSF Expenses

Where an SMSF has retirement phase pension accounts and accumulation accounts there may be a need to apportion expenses to determine the deductible component. This fact sheet expands on this concept and addresses the methods available to determine the deductible component of expenses where apportionment is required.

Expense apportionment

Expenses are generally tax deductible when they are linked to gaining or producing assessable income. When a retirement phase pension is commenced the income from the underlying assets is treated as tax exempt. This is referred to as Exempt Current Pension Income (ECPI). Expenses are similarly treated as non-deductible, because there is no assessable income to be offset with the associated deductible expenses. Expenses that are only incurred in gaining or producing non-assessable income are not deductible under section 8-1 of the Income Tax Assessment Act 1997.

Expenses that are incurred partly in producing assessable income and partly in producing non-assessable income must be apportioned to determine the deductible amount under section 8-1. The expense will only be deductible to the extent to which it is incurred in producing assessable income.

To further complicate things, some expenses can still be claimed in full such as the ATO supervisory levy and death/disability insurance premiums. Expenditure that is specifically deductible under section 25-5 (tax related expenses) does not need to be apportioned.

In short, in an SMSF where the fund is solely in accumulation phase, the eligible expenses can be treated as tax deductions. If the SMSF is completely supporting retirement phase pension accounts, then all of the expenses are treated as non-deductible. When an SMSF is receiving contributions and paying pensions (accumulation and retirement phase interests) in the same financial year not all expenses can be treated as deductible or non-deductible and the method for apportionment depends on the specific circumstances. Where this is the case, the expenses should be reviewed and classified as distinct and severable, or as indifferent expenses to determine their deductibility.

Distinct and severable expenses

A distinct and severable expense can clearly be identified as relating to an accumulation or retirement phase account. For example, a pension administration fee is clearly related to the administration of the retirement phase accounts. This expense will always be treated as non-deductible as it does not relate to gaining or producing assessable income. Distinct and severable expenses are often easier to identify when a fund is segregated for tax purposes as they will be paid from the relevant bank account linked to the accumulation or retirement phase account. For a distinct and severable expense where part clearly relates to producing assessable income and part does not, the expense is required to be apportioned based on the ratio of the part that relates to producing assessable income and the part that does not. This method of apportionment should be used where possible.

Indifferent expenses

An indifferent expense is not clearly related to the accumulation or retirement accounts and will be apportioned in the tax return between deductible and non-deductible amounts. There is no single method to apportion expenses however Taxation Ruling 93/17 provides examples and guidance to follow in apportioning expenses. A 'fair and reasonable' basis must be followed to determine the extent to which the expense relates to assessable income. There are two methods explained however they are not the only methods available and other methods are considered to be acceptable if "it can be demonstrated that they give a fair and reasonable assessment of the extent to which the outlay relates to assessable income." The two generally accepted methods of apportionment are explored briefly below.

Common Apportionment methods

The most common calculations are both income-based approaches which apportion investment expenses and general administrative expenses separately.

Method 1 – Investment expenses

The investment income approach uses the fund's assessable investment income as a percentage of total investment income to calculate the deductible portion of investment expenses and is expressed through the following formula.

$$\text{Expenditure} \quad \times \quad \frac{\text{Assessable investment income}}{\text{Total investment income}}$$

Note: Assessable investment income for this purpose includes both ordinary and statutory income from investments such as net capital gains and imputation credits (excludes exempt current pension income). Total investment income includes assessable investment income plus non-assessable investment income.

For example

A fund has total income of $10,000.
$7,000 of this is assessable and was derived from investments.

The remaining $3,000 is not assessable, as determined by an actuarial certificate.

Investment management fees from a financial adviser are incurred for $2,000.

The calculation to determine how much of the $2,000 investment expense can be claimed as a tax deduction is as follows:

$$\$2{,}000 \times (\$7{,}000 \div \$10{,}000) = \$1{,}400$$

Method 2 – General administration expenses

This approach uses the fund's assessable income as a percentage of total income to calculate the deductible portion of expenses and is expressed through the following formula:

$$\text{General administrative expenses} \quad \times \quad \frac{\text{Assessable income}}{\text{Total income}}$$

Note: Assessable income for this purpose includes both ordinary and statutory income such as net capital gains and imputation credits (excludes exempt current pension income). All non-concessional contributions and rollovers to the fund are also included. Total income includes assessable income plus exempt income and non-assessable non-exempt income.

For example

A fund has total income of $60,000.
$27,000 of this income is assessable.

The remaining $15,000 is from member non-concessional contributions.

Accounting fees of $2,400 are incurred.

The calculation for the tax deductible portion of the general administration expense is as follows:

$$\$2{,}400 \times [(\$27{,}000 + \$15{,}000) \div \$60{,}000] = \$1{,}680$$

Actuary percentage

Another 'fair and reasonable' approach to apportioning expenses is where an actuary certificate is obtained by the fund for the relevant financial year. Where a fund is not segregated, the assets are 'pooled'. When the assets are pooled it cannot be determined if they support the accumulation or pension accounts. When it comes to the completion of the tax return, the trustees will engage an actuary to calculate the exempt current pension income (ECPI). This calculation is summarised on an actuarial certificate and displays the ECPI as a percentage of total income. The calculation is a daily weighted average of the unsegregated retirement phase liabilities dividend by the daily weighted average of the unsegregated superannuation liabilities.

The simplest expense apportionment method is to use this ECPI percentage and apply it to the indifferent expenses. It should be noted that the simplest method will not always produce the best outcome, just the quickest.

Expenditure x Assessable income %

Where assessable income % is:
100% minus exempt income % per actuary certificate

For example, if an actuary has calculated that a fund's ECPI percentage is 75% (that is, 75% of total income relates to pension accounts, and is exempt from tax) then this can be applied to an expense totalling $1,000. In the tax return the expense will be split as $250 deductible and $750 as non-deductible.

Considerations

Where a particular method of apportionment is selected it should be applied consistently over the years unless there is a specific reason to change methods. Several changes in methodology purely to provide an increased tax benefit to the fund could attract the attention of the auditor. The overriding outcome must be a 'fair and reasonable' approach.

In conclusion the claiming of a tax deduction should be considered carefully for each expense, and the nature should always be kept in mind.