Unsegregated SMSFs and Actuarial Requirements

As a rule, SMSFs can either use the segregated or unsegregated/proportionate method to determine their Exempt Current Pension income (ECPI). However, there are instances where segregation is not allowed and the unsegregated method, requiring an actuarial certificate, must be used. This fact sheet will provide an overview of using the unsegregated/actuarial method.

Since the introduction of the transfer balance cap, determining the income tax exemption for SMSFs paying retirement phase income streams is not as straightforward as it once was. The transfer balance cap limits how much a member can have in a retirement phase pension and as such anyone with balances above the cap who commences a pension will have an amount in retirement phase and the excess amount above the cap will be in accumulation phase. For these members, they will need to use the unsegregated/actuarial method to calculate the ECPI of their fund each financial year.

In addition to contemplating what the actuarial certificate requirements currently are for fund's paying retirement phase pensions and what the potential benefits of the unsegregated approach can be we will also provide a brief overview of when segregation may be appropriate and allowable.

What is ECPI?

Both ordinary and statutory income earned on assets that are supporting retirement phase income streams is exempt from income tax and known as ECPI. In the event that a fund generates assessable and exempt income the amount that is exempt will be recorded in the SMSF annual return. The calculation of gross income less ECPI will give you the final assessable income of the fund. Assessable contributions and non-arm's length income (NALI) are excluded from ECPI calculations.

ECPI is only relevant to retirement phase income streams, therefore any Transition to Retirement Income Streams (TRIS) in accumulation phase are not able to calculate and claim ECPI. Once a TRIS moves to retirement phase then ECPI can be claimed in the annual return.

What are the methods available to calculate ECPI?

Segregated method

The segregated method is one such method to calculate the amount of ECPI an SMSF can claim. All income from segregated current pension assets is ECPI. Segregation is generally used where the SMSF's assets are actually segregated and the ownership of specific assets is identified as either supporting the retirement phase or supporting the accumulation phase. As separate portfolios/assets are being held it is possible to clearly attribute any earnings to the specific phase it supports. The assets supporting retirement phase income streams must have the sole purpose of paying retirement phase income streams.

All of the income from segregated current pension assets is ECPI under this method. Furthermore, capital gains and losses on segregated current pension assets are disregarded where a capital gains tax event occurs. Whilst under this method it is simple to identify which earnings are ECPI, there is additional work involved by the trustee in properly administering the fund so it can be more costly.

Segregation cannot be used for income tax purposes in the following circumstances:

- Where any member of an SMSF has a total superannuation balance of $1.6 million or more as at 30th June of the prior year (in every fund that they are a member, not just the SMSF) AND
- That/those member/s with more than $1.6 million are in receipt of a retirement phase income stream from any super fund

In these events, the fund's assets are considered to be 'disregarded small fund assets' and can't be treated as segregated current pension assets even in situations where the fund is 100% in retirement phase. The SMSF must adopt the unsegregated/acutarial method where segregation is not allowable for tax purposes. This is the case even where 100% of the assets are supporting retirement phase income streams. (NOTE: the Government have indicated that this may change from 1 July 2021 and funds that are 100% paying retirement phase income streams but have disregarded small fund assets will be able to elect the segregated approach – legislation pending).

Where a fund is 100% in retirement phase and does not have disregarded small fund assets, all assets are segregated current pension assets and the segregated method is used to determine ECPI.

Unsegregated/Actuarial method

Where a fund cannot be segregated or chooses not to be segregated, they are unsegregated. This is the most commonly used method for calculating ECPI and is used where specific assets are not set aside to support retirement phase income streams. Where a fund is unsegregated it is classed as being 'pooled' for tax purposes. This refers to the fund assets being in a single pool, and ownership by the retirement or accumulation phase accounts is not identifiable. This method will often be referred to as the proportionate or actuarial method, these terms are interchangeable.

The ECPI is determine by the 'exempt proportion' of the income based of the proportion of the fund's total liabilities that are current pension liabilities. In other words, the proportion of the fund's account balances that are retirement phase income streams. Under this method, the fund will need to obtain an actuarial certificate each financial year to determine the proportion of the fund's income that is applicable to the accumulation phase vs the retirement phase. The exempt proportion is applied against the assessable income for the period of the year that the SMSF is using this method to determine ECPI.

This method reduces the complexity of operations for trustees, as only one investment portfolio is held, and this simplifies the administration. As a result of this simplicity, the proportionate method is widely adopted as the preferred method of calculating ECPI and income tax.

When can the unsegregated/proportionate method be used?

As noted earlier, currently where an SMSF has disregarded small fund assets they are unable to use the segregated method to determine ECPI even if 100% of the assets are supporting retirement phase income streams. They must use the proportionate method and obtain an actuarial certificate.

Where a fund does not want to segregate or not all assets are supporting retirement phase income streams, then they can use this proportionate approach.

It may also be necessary to change methods during the year where there is a change in the member's accounts and they are using the proportionate approach but then move to being 100% in retirement phase (unless they have disregarded small fund assets) or vice versa. Where 100% in retirement phase, the segregated method will be used for that portion of the year. There is also a proposal to change this from 1 July 2021 to allow funds just to use one method in a year, which would be the proportionate approach.

Where part of the fund is in retirement phase and the rest is in accumulation phase, the proportionate method can be used and the fund will need an actuarial certificate for that portion of the financial year.

One actuarial certificate will be required for the period(s) the proportionate method is used even where the method used is changed multiple times within the financial year. It will not cover the period(s) where the segregated method is used.

What is involved in an actuarial certificate?

An actuarial certificate will advise the proportion that can be applied to the SMSF's income to determine the ECPI.

The exempt income proportion is calculated under section 295-390 of the Income Tax Assessment Act 1997 as follows:

$$\frac{\text{Average value of current pension liabilities}}{\text{Average value of superannuation liabilities}}$$

The average values used in the calculation of the exempt income proportion are determined using a daily weighted average calculation. The calculation therefore takes into account the following significant information:

- Each member's opening account balances for their accumulation and pension accounts
- Pension commencements and commutations including the size and timing
- Contributions, pension payments, lump sums and transfers including the size and timing
- Concessional contributions tax payable

The calculation is effectively the proportion of the fund supporting pensions and is applied to the fund's ordinary assessable income and capital gains to determine the ECPI. Assessable contributions and non-arm's length income (NALI) are excluded from the ECPI calculations. Any income and capital gains on segregated assets are also excluded from the calculations. This can be summarised in the following formula:

ECPI = [Income (excluding contributions and NALI) x Exempt income proportion] + Income from segregated current pension assets

The calculation of gross income less ECPI will give you the total assessable income of the fund.

Benefits of using unsegregated approach

Where a fund chooses not to segregate or is prohibited from segregating due to disregarded small fund assets, the unsegregated approach does offer some benefits to consider as follows:

- Simplicity as all assets are pooled
- Simplicity can lead to easier administration, less time spent and lower costs involved
- Capital losses can be preserved and can be carried forward and used in future. This may be of benefit in the long term if the dependants of the current members join the fund. This is in contrast to segregated funds where all capital losses on segregated current pension assets are ignored.
- Pooling the member accounts may give the SMSF greater investment opportunities for larger assets. Where bulky assets are held such as property they may not be able to be segregated between member accounts and this is not an issue under the unsegregated method.

As can be seen there are instances where segregation must be used and instances where it cannot be used due to disregarded small fund assets. Where the unsegregated approach is the alternative used, the calculation of the exempt proportion is obtained by an actuary and is a more straightforward approach to determining ECPI. It offers several advantages compared to the segregated approach however like most things this all comes down to the specific circumstances of each SMSF and what method provides the best outcome.