#137 Heffron SuperNews
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In the new world, is it worth maintaining a separately invested pool of assets for a client's pension account?

Introduction

The new world from 1 July 2017 brings many important changes for those with pension accounts in excess of $1.6m. For a start, those receiving "full" pensions (as opposed to transition to retirement pensions) will need to "roll back" enough to their pension account to fall within the new $1.6m limit on pension accounts.

When this limit was first announced, we speculated that "segregation" would become more common – ie, people with more than $1.6m in their SMSF would choose to set aside a specific investment portfolio to support their pension account(s) and manage their "non pension" assets quite separately. The idea behind this approach is generally to ensure that the trustee can control which fund assets are never subject to tax on their investment earnings (the pension assets) and also how their pension accounts grow (in line with earnings on those assets).

In the end, the new legislation scotched that idea. From 1 July 2017, SMSFs with members who have more than $1.6m in super at 30 June with a pension "somewhere":

- regardless of whether that super is all in their SMSF;
- regardless of whether it is all in pension phase;
- regardless of whether their pensions were within their pension balance cap when they pension started

will not be able to segregate for tax purposes. For anyone. In theory, even an SMSF member with a $1 balance could effectively prevent the other members from segregating in the normal way if he or she has at least $1.6m in pension phase in another fund.

What options remain?

There are two:

1. **A second superannuation fund**. In its simplest form, this would involve having pension accounts (and the associated assets) in one fund and accumulation accounts (and associated assets) in another. This achieves segregation because the two sets of assets are owned by different legal entities. Clearly, the pension accounts will rise and fall with the value of the assets in that fund and income earned on those assets will be completely exempt from tax as long as the pensions remain in place. This method achieves exactly what traditional segregation achieves but requires two superannuation funds and therefore introduces additional costs.

2. **Investment allocation without tax segregation**. This is a more subtle and less "pure" alternative. Under this approach, the assets would all remain in one fund. The trustee would notionally allocate different assets to different members or different types of accounts. Earnings would be added to those accounts in line with the earnings on the relevant assets rather than a proportionate share of all the fund's earnings. However, in line with the new prohibition on genuine segregation from a tax perspective, the fund's tax return would be prepared as if all investment earnings were shared proportionately across all accounts. This method achieves just one of the goals of traditional segregation – it allows the trustee to ensure that the pension account(s) grow in line with a specific set of assets rather than the returns across the fund as a whole. However, it doesn't provide the second benefit – the ability to specifically choose which assets should be treated as producing income which is completely exempt from income tax.

Both methods have advantages and disadvantages and we have carried out some modelling to assess when they might be useful.

A word of caution

The first thing to bear in mind when considering this modelling is that it is almost impossible to compare like with like. For example:

- Separating the investments (whether via a separate fund or different investment pools within the same fund) is designed to ensure that the pension account grows more than if the investments were pooled. A higher pension account means higher minimum withdrawals. Assuming that the individual's spending needs are the same under both scenarios, higher minimum withdrawals means that the member will save more in their own name (where earnings will be taxed) – negating some of the benefits of the strategy;
- The apparent success of the strategy is partly just a function of the fact that if the pension account grows more quickly, the individual ends up with more of his or her superannuation exposed to a higher return. *If we knew for certain* that one investment strategy would produce a higher return than another, the obvious solution would be to invest the whole

fund in line with that investment strategy! The reason individuals don't do so is to provide some diversification that matches their overall risk tolerance. Hence in our comments below we have specifically adjusted the results to remove this impact.

Two superannuation funds to achieve segregation of pension assets

The chief disadvantage of this method is the additional cost of running a second superannuation fund. On the other hand, it does permit the member to ensure that the pension fund has, for example the assets expected to generate the higher returns over the long term.

Generally, we expect clients will seek to achieve two things by doing this:

- Maximise the growth in their pension accounts rather than accumulation accounts; and/or
- Maximise the overall tax exemption on investment income.

Our modelling suggests that the key variables here are:

- The cost of running the second fund (we've assumed $2k pa increasing in line with inflation);
- The size of the fund
- The disparity between the return profiles of the pension and accumulation assets (both their relative size and the proportion which represents taxable income)
- And the rate at which the pension account is drawn down.

We considered a single member fund (age 65) and assumed that regardless of the fund size, the first $1.6m would be put into a pension account and the remainder would stay in superannuation but be held in an accumulation account. We also assumed that 50% of the fund's earnings each year would be potentially taxable income in the fund. (In other words, if the earning rate was assumed to be 6% pa, we assumed that the taxable component of this would be 3% pa.)

We've expressed all results in "real" terms (ie adjusted for inflation at 2.5% pa). Our conclusions are broadly as follows.

In theory, the strategy looks attractive with even quite modest differentials in return. For example let's assume the fund has an initial value of $5m ($1.6m in pension phase, $3.4m in accumulation phase) and the pension return is only 2% pa higher than the accumulation return (say 6% pa v 4% pa).

Our modelling indicates a real benefit to this strategy of around $15k after 10 years, $45k after 15 years. The numbers are even higher when the return differential is higher or the fund size is larger.

However, most of this benefit simply comes from the fact that the individual has more of their investments exposed to the higher return. (As this increases in line with growth in the pension account.) As mentioned earlier, if we knew for certain that one pool of assets would definitely outperform another, the best strategy would be to invest all assets at the higher return. A simple comparison of this nature is therefore somewhat misleading – it's a little like asking "if I invest more of my super in assets that generate better returns will I end up wealthier?" to which the answer is obviously "yes".

A better question would be "has this way of dividing up my investments had a positive impact on my tax position?" To really answer this question we need to assume that overall, the individual's investment mix will be the same regardless of whether they have one fund or two and that in total they will achieve the same investment returns in either case. The purpose of the strategy is purely to change the tax result by ensuring that the higher returns are skewed to the pension fund. Under this scenario, we have a very different result.

On these adjusted calculations, a 2% pa differential between pension and accumulation investment returns was not really enough to warrant putting the strategy in place unless the fund was very large ($10m+). The benefits were not high enough to outweigh the costs.

The savings could be more meaningful with a larger gap between the pension and accumulation asset returns. For example, if there was a 4% gap between them (investment returns of 8% pa for the pension account and 4% pa for the accumulation account), the benefit of having a second fund in terms of a reduction in future taxes (after allowing for the cost of running the second fund) could be in the order of the amounts shown below:

	Net benefit (reduced taxes on fund income) after:		
Initial fund balance	**10 years**	**15 years**	**20 years**
$ 5.0m	$20k	$50k	$85k
$ 7.5m	$30k	$60k	$105k
$10.0m	$30k	$65k	$115k
$15.0m	$35k	$70k	$120k

A 5% gap would change the above figures as follows:

	Net benefit (reduced taxes on fund income) after:		
Initial fund balance	**10 years**	**15 years**	**20 years**
$ 5.0m	$40k	$85k	$125k
$ 7.5m	$50k	$100k	$180k
$10.0m	$50k	$110k	$195k
$15.0m	$55k	$115k	$205k

On balance it would appear that quite a large gap between the return expectations for the two sets of assets is required (as well as a reasonably long timeframe) in order for a material benefit to emerge.

Overall, given the time frames involved and the relatively substantial difference in returns required, it seems difficult to make a very strong case for running a second fund purely to separate pension and non pension assets. Note that this should not be confused with running a second fund to quarantine different tax components – that is an entirely different issue and is far more likely to stack up as a strategy.

A single superannuation fund but with notional investment portfolios driving return allocation

Separately we considered the second approach – ie, run the fund's investments through a single fund but have the pension account(s) grow in line with a specific set of assets (the pension assets). As mentioned earlier, the new ban on segregation means that the fund's tax return must be prepared ignoring this notional allocation of fund assets. Instead, the fund's tax exemption will be determined based on a proportionate share of all fund income.

While this approach comes at a lower cost (no second superannuation fund), the benefits are actually even lower. This is because we lose one of the key benefits of the strategy – to drive which returns are tax free v taxable.

Conclusion

Overall, it would appear that if:

- Differences between returns on the assets the member would ideally like supporting the pension and accumulation accounts are likely to be material, there is some modest benefit to be gained from ensuring the returns are specifically targeted in the way a traditional segregated fund would achieve;
- It is likely that the benefit will be best realised using a second fund rather than a notional allocation of investments within a single fund as this will allow the fund's tax exemption to be specifically linked to the returns on the pension assets.