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Pension funds in 2016/17 – claiming the right tax exemption

Introduction

Our last article (Heffron SuperNews Issue #142 – Top 8 things you need to know about CGT relief) highlighted some of the issues emerging as clients affected by the 2017 superannuation reforms start to lodge 2016/17 returns.

In that article we focused on CGT relief. However, exactly how to approach 2016/17 actuarial certificates is another question coming up far more frequently this year than ever before.

So what exactly are practitioners doing? What are the common questions? What are the risks and opportunities to keep top of mind in this transition period?

In this edition of Heffron SuperNews we look at just one group of SMSFs. Those that:

- have no defined benefit pensions;
- were entirely in pension phase for most of 2016/17; but
- became "mixed" (ie a combination of pension and accumulation accounts) at some point in 2016/17 – often late in the year.

Firstly, however, we have briefly recapped the rules that drive funds to obtain an actuarial certificate.

Recap – when do I actually need an actuarial certificate for 2016/17?

Perhaps the most important point to bear in mind is that actuarial certificates are not a ***compliance requirement*** for any fund unless it pays defined benefit pensions.

The purpose of an actuarial certificate for non defined benefit funds is purely to allow a fund to claim a tax exemption on some of its investment income for any period where it has a mixture of pension and accumulation accounts.

This has some important consequences:

- If the fund is entirely in pension phase all year, no actuarial certificate is required;
- If the fund does have a period where it has a mix of accumulation and pension accounts but there is ***no income*** earned during that period, there is no need for an actuarial certificate – it has no "job to do";
- Similarly, if there is ***very little income*** earned during the relevant period, it would be entirely reasonable for the trustee to decide to simply not claim a tax exemption on any of that income. Making that choice means no actuarial certificate is required. In the extreme this could even apply in a fund that had a mixture of pension and accumulation accounts ***all year*** but earned very little income (or perhaps its income was fully offset by deductible expenses). Choosing not to obtain an actuarial certificate does not invalidate the pension.

Bearing that in mind, how might those with pension funds choose to claim a tax exemption in 2016/17?

Approach 1 – no actuarial certificate at all

This will be relevant for funds that are entirely in pension phase for almost all the year and receive little or no investment income once they become "pooled" (ie have a mixture of pension and accumulation accounts).

The classic case will be a fund that only has accumulation accounts for the first time on 30 June 2017 because:

- a retirement pension has been partly "rolled back" to $1.6m; or
- someone with a transition to retirement pension (and no accumulation account) chose to terminate it on 30 June 2017.

Technically the treatment here is:

- the fund is entirely in pension phase up until the accumulation accounts are created on 30 June 2017 (and treated as "segregated" until that point);
- all investment income is therefore exempt until that point and all capital gains and losses are disregarded (including any capital gains realized as part of the CGT relief process);
- no actuarial certificate is required for this exemption – in 2016/17, income on segregated pension assets is automatically exempt from tax;
- the trustee chooses not to obtain an actuarial certificate to exempt any income earned after the accumulation accounts are created.

They key here will be timing. Ideally the "roll back" will have been the very last event that occurred in 2016/17.

In a practical sense, this will almost have to be the case by definition – otherwise how would it be possible to ensure that the pension balance was exactly $1.6m on 30 June 2017?

In our practice we are generally simply ensuring that the pension documentation or year end minutes reflect this "order".

Doing this means there is no need to obtain an actuarial certificate for 2016/17 as there is no income to which it could be applied.

Where it is possible to do this it will almost always provide the simplest and most tax effective outcome.

We are aware that some of the major software packages effectively assume this treatment anyway while others assume that the commutation occurred on 29 June 2017 (and so the fund was a mixture of pension and accumulation accounts for the entire day of 30 June 2017). Unfortunately some manual manipulation is often required to ensure that the fund's accounting software correctly reflects the action the trustee has taken.

As mentioned earlier, the decision not to obtain an actuarial certificate is one the trustee can make at any time. Even a fund where the pension roll backs clearly occurred earlier (say 20 June 2017) might adopt this approach if there was little or no income earned after 20 June 2017. It would simply be important to ensure that income after that date was treated as being taxable.

Approach 2 – an actuarial certificate for just the investment income earned after the fund became "pooled"

What if the fund became pooled on or before 30 June 2017 and there was a significant amount of income earned during the pooled phase?

Common causes will be:

- The receipt of a contribution [1];
- The choice to classify a pension payment or a partial commutation as lump sum since doing so creates an accumulation obligation and therefore stops the fund being entirely in pension phase [1];
- Pension roll backs that occurred at some date other than 30 June 2017; and
- Pension roll backs that occurred on 30 June 2017 but before the receipt of income on that date (and the amount of income is significant).

Any of these could cause the fund to become pooled at some point before the receipt of significant amounts of income – encouraging the trustee to obtain an actuarial certificate so that at least a partial exemption can be claimed on this subsequent income.

Technically the certificate would still be provided for the full year (actuaries are not allowed to provide part year certificates). However, it only applies to income earned on ***pooled*** assets not the income earned while the fund was ***segregated***.

Example. A $2m fund was entirely in pension phase until 1 March 2017 when a contribution of $180,000 was received. The member also rolled $400,000 back to accumulation phase on 30 June 2017.

The actuary would calculate the exempt percentage as follows:

- Account balances and income up to 1 March 2017 would be ignored entirely on the basis that the fund was 100% in pension phase (and therefore segregated) during that time;
- The average pension and accumulation account balances post 1 March 2017 would give rise to an actuarial % of approximately 92%. (This reflects the fact that for most of that 4 month period, the accumulation balance was $180,000 and the pension balance was $2m – ie 92% of the fund was in pension phase.);
- This actuarial % would apply for the whole year <u>but only to income earned on unsegregated assets</u>. The practical outcome is that it would therefore just be applied to income after 1 March 2017 (which is why it is often mistakenly assumed that the actuary has provided a part-year certificate).

If the fund's investment income was exactly $10,000 per month (interest) and there were no investment related expenses that were potentially tax deductible:

- The first 8 months' income would be entirely exempt from tax (on the basis that it was earned on segregated pension assets);
- The next 4 months' income would be 92% exempt from tax, 8% taxable.

[1] Bear in mind that where the fund has become pooled because a contribution has been received or an accumulation liability has been created pending the payment of a lump sum, it is often possible to keep the fund segregated by creating segregated 'sub accounts' within a single bank account. This is something which should be done before the contributions is received / lump sum liability is created. Under this scenario, the income on the accumulation sub-account would be fully taxable but bear in mind that this may be $nil in any case if the liability is removed shortly afterwards – eg by converting the contribution to a pension or withdrawing the lump sum amount from the fund.

The case where a fund only has pooled assets for 1 day (30 June 2017) is simply an extreme version of this – the actuarial calculations would reflect account balances for just that 1 day.

For the actuary to do these calculations, the data to be provided should include all relevant roll backs, particularly if the certificate is effectively only applicable to income on 1 day.

Approach 3 – an actuarial certificate for all income for the whole year as if the fund was never "segregated"

Approaches 1 and 2 are both clearly supported by the law and are consistent with the ATO's view on how the relevant provisions operate.

Approach 3 is a variation that the ATO believes is not valid in law even though it has been common industry practice for some time. Because of the difference in views, the ATO was asked to specifically approve it as a temporary measure for 2016/17.

The Commissioner stopped short of providing specific endorsement but did offer that "no compliance activity" would be directed at funds that relied on Approach 3 for 2016/17 and earlier years.

Under Approach 3, a fund would obtain an actuarial certificate for the whole year as if none of the assets were ever segregated at any time. The % in many cases would be close to 100% and it would apply to all assessable investment income (including capital gains) during the year.

In the previous example, the % would be approximately 97% [2] and would be applied to the full $120,000 fund income for 2016/17.

In some ways this seems simple and is certainly consistent with industry practice in the past.

The challenges are:

- If the fund is not regarded as segregated during the year, all capital gains (even those while the fund was actually entirely in pension phase) should be treated consistently with the "pooled" approach and would therefore reduce capital losses carried forward from 1 July 2016;

- In fact in theory this treatment should also apply to capital gains realized as a result of the CGT relief (for tax purposes these are just ordinary capital gains). While the ATO has made it clear that it expects funds to still use the segregated method for applying CGT relief, *the way in which the resulting gains are handled* is something on which the CGT relief provisions are completely silent (suggesting they should be treated just like any other gains during 2016/17). However we understand the ATO is unlikely to pursue this given their previous statements about not directing compliance resources to this issue for 2016/17.

Where a fund is using Approach 3, it is possible for us to prepare the actuarial certificate without the 30 June 2017 roll back transactions having been processed as they are unlikely to have a material impact on the results.

Which approach should most funds adopt?

Approach 1 where:

- the only trigger for creating accumulation accounts is the rolling back of pensions to $1.6m or termination of transition to retirement income streams.

  Ensure the creation of the accumulation accounts is the very last event of 2016/17 and hence all investment income is tax exempt on the basis that the fund was segregated (fully in pension phase) at the time. This will cover a great many funds.

- accumulation accounts have been created earlier in the year but the use of sub-accounts means that they have not disrupted the fund's segregation at that time.

  Earnings on the accumulation sub-account will be subject to tax but as mentioned earlier this may be trivial.

  Just one risk to bear in mind - remember that a key condition for CGT relief on the "segregated" method is that the assets stop being segregated at some point before 1 July 2017. Hence it may also be important to **end** the sub accounts on 30 June 2017 if they remain in place at that time.

We expect that Approach 3 should be used relatively rarely although we can understand why it might be preferred due to system constraints or simplicity. Otherwise, it should ideally only be used when:

[2] This reflects the fact that the fund had approximately $2m in pension phase almost all year, $180,000 in accumulation phase for 4 months and then an additional $400,000 in accumulation phase on 30 June 2017.

- the fund received a large amount of its income for the year after it became pooled; and

- there were no carried forward losses at 1 July 2016 (or the gains during 2016/17 will not reduce these to any great extent).

In many cases, Approach 2 will be preferable to this.

Conclusion

As if 2016/17 wasn't confusing enough, 2017/18 is actually different again when it comes to tax exemptions, actuarial certificates and the treatment of capital gains. In a future edition of our newsletter we will cover the requirements for 2017/18 and beyond.