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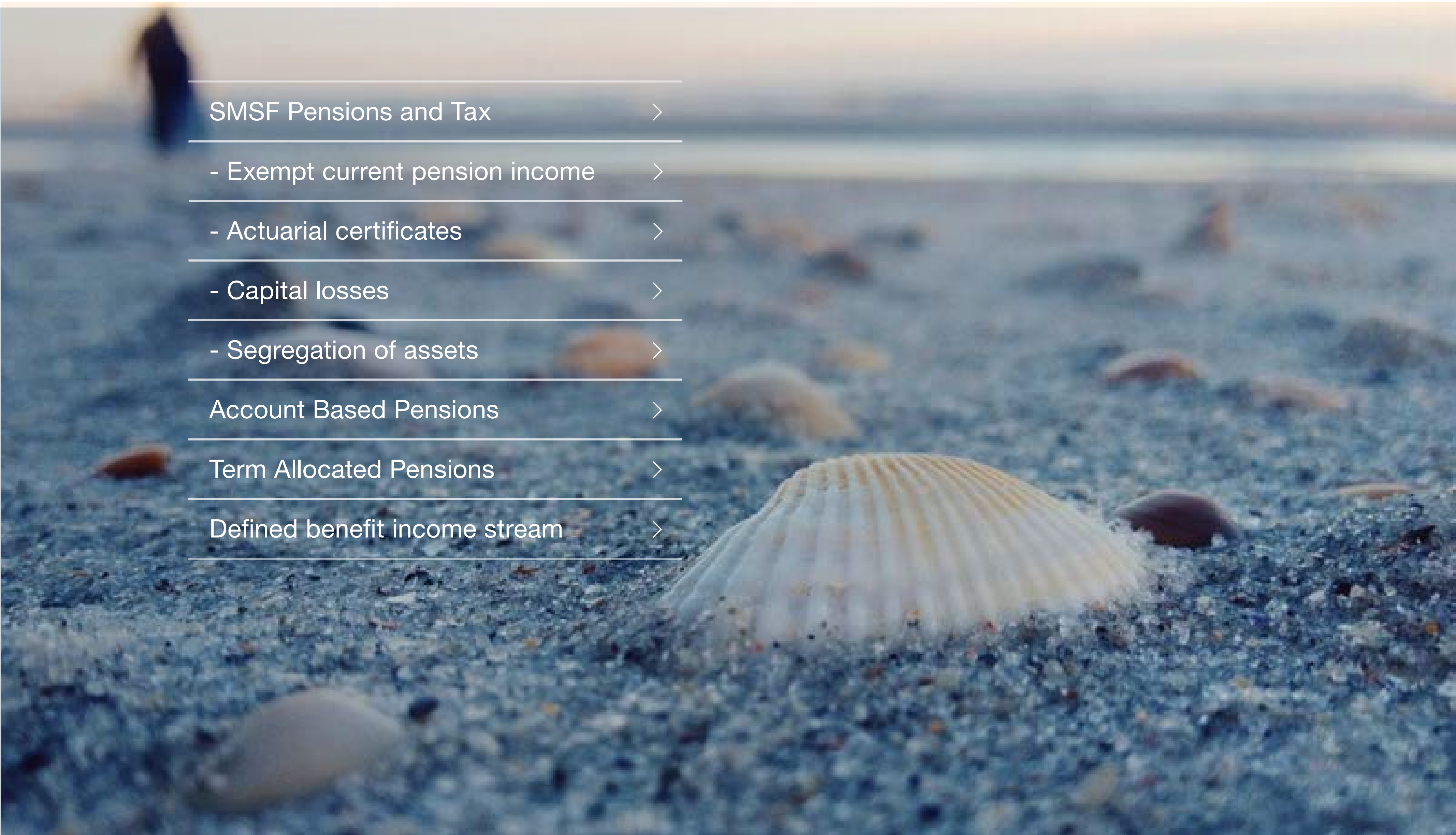
TechKnowledge

Income Streams



The most common income stream paid from an SMSF is an account based pension

Income Streams

SMSF Pensions and Tax

There are a number of types of income streams which can be paid from superannuation funds or with superannuation benefits. However, even though some, such as term allocated pensions and defined benefit income streams such as lifetime and term certain pensions are generally no longer allowed to be commenced within an SMSF, there are many funds with these types of income streams which would generally have been put in place before the relevant cut-off date. Further information on these income streams can be found below:

- Defined benefit income streams
- Term allocated pensions

By far the most common income stream paid from an SMSF is an account based pension (ABP) which is generally treated similarly to an ABP in any public offer fund, though the following section details some important exceptions

- Account based pensions

SMSF Pensions and Tax

As mentioned previously, there is no tax on the earnings of assets supporting a pension. This applies to both Capital Gains Tax and Income Tax though it is important to understand the mechanism by which the concession is applied to ensure the best outcome for the client.

Exempt Current Pension Income

The first important concept is that of the exempt current pension income (ECPI) which is the percentage of the earnings of a fund which are exempt from tax for that year. This figure is obtained from an actuary who usually calculates it by determining the 'average' percentage of assets of the fund supporting pensions throughout the year.

As such, where a husband and wife had a fund with similar balances and one was in pension phase for the whole of the year and the other was in accumulation, the ECPI would be approximately 50%, meaning that 50 cents of every dollar earned would need to be included in the assessable income of the fund.

In addition, if the fund made a capital gain, the gain would first be reduced by the losses carried forward by the fund and the resulting gain would have the general discount applied (33%) where the asset was held for more than 12 months. Finally, only 50% of the discounted gain would have to be included in the assessable income of the fund.

tax on earnings of assets supporting a pension. 0%

Actuarial certificates

However, actuarial certificates are not required in all circumstances where there is a pension within the fund. Where the entire fund balance is supporting income streams, the pension is deemed to be segregated which in turn means that all earnings during that period are tax-free and no actuarial certificate is needed for that period.

Importantly, this period of segregation can be a full year or part of a year. For example, consider a single member fund who converts his entire balance to pension phase on 1 January of a financial year. The period from 1 January to 30 June will be a period when the fund was segregated and all assets were supporting a pension and therefore, all earnings during that period are tax-free.

Tax would be payable on the period from 1 July up to the 1 January when the pension commenced and if the fund had a mixture of accumulation and pension assets for that period an actuarial certificate would be required for that period.

Capital losses

An interesting effect of the tax-exemption of earnings of assets supporting a pension is how it interacts with the capital gains tax regime. In the situation above any capital losses realised in the second half of the year (when tax was not payable) would be disregarded and unable to carried forward to be used in later financial years.

However, if the loss was realised in the first half of the year (when tax was payable) the loss could be recorded and carried forward to be used in a later financial year. This is true even if the amount in accumulation is quite small. For example, a $1 million fund with only $1,000 in accumulation would be able to carry forward the entire loss to future financial years.

Segregation of assets

While over 90% of funds use a pooled assets strategy, there are a number of benefits for considering a segregated fund method. There are a number of ways to segregate a fund but a popular and beneficial one is to segregate some assets to the pensions of the fund and other assets to the accumulation interests. This means that the earnings on some assets are tax-free and on others is fully taxable.

For example, you could have a property in the fund segregated to the accumulation interest and the share portfolio segregated to the pension interests. This would result in the dividends and realised capital gains from the shares being disregarded while the rental income would be fully taxable.

Account Based Pensions

For an SMSF member to commence an account based pension (ABP) within their SMSF, they are required to satisfy the same conditions of release that a member of a public offer fund would have to. While it is possible for an SMSF trust deed to contain a governing rule restricting access to pension further, such as not allowing transition to retirement pensions, this would be an unusual situation.

Furthermore, the SMSF trustee has to ensure the conditions for a valid ABP have been met. There are a few issues related to ABPs which are unique to SMSFs.

The main ones were clarified in the ATO's Taxation Ruling 2013/5 which addressed the ATO's views on when a pension commences and ceases. Their view is that an income stream cannot occur prior to the day established as the commencement day in the terms and conditions agreed between the member and the trustee that will govern the superannuation income stream. As such, best practice would be for the member to apply in writing to the trustee to commence an ABP and on that application specify all the relevant details for the ABP such as the amount of benefits to be used to purchase the income stream, how much and how regular the payments are and the commencement date which shouldn't be earlier than the date of the application.

The same ruling addressed the treatment of an ABP where the minimum pension payment had not been made. It was their view that as the minimum requirements for an income stream were not met, there had been no income stream in existence for the entire year and tax would be payable on the earnings of the assets which had been used to support that income stream.

However, the ATO have provided an exception to this rule through their general administration powers. In summary, the ATO will allow a fund to claim the tax concession for earnings on income stream supporting assets where, amongst other requirements:

- the trustee failed to pay the minimum pension amount in that income year because of either:
  - an honest mistake made by the trustee resulting in a underpayment of one-twelfth or less of the minimum payment amount
  - matters outside the control of the trustee.
- the trustee makes a catch-up payment as soon as practicable (in the current financial year) after finding the underpayment

Where these conditions are satisfied, the pension is deemed to have continued with the same taxable and tax-free proportions and the payments can be treated by the members as income stream payments, not lump sum withdrawals.

When does an ABP cease?

The aforementioned tax ruling stated that an ABP ceases on the death of the pensioner if there is no automatic reversionary beneficiary. This would have resulted in the tax concessions ceasing on the death of the pensioner and any subsequent disposals would be subject to CGT.

However, the government changed the legislation before the ruling was finalised so that while a pension still ceases on the death of the pensioner, the tax concessions continue until the death benefits are paid.

Available prior to 1 September 2007

Term Allocated Pensions

Term allocated pensions (TAPs), also known as market linked income streams were available until 19 September 2007 and their primary benefit was that they were treated concessionally for Centrelink purposes, namely by entitling them to a 50% asset test exemption.

To qualify for this concession, the TAP had to comply with strict rules regarding terms and allowable payments.

Where a member has a TAP within their SMSF, they can commute that TAP and rollover the proceeds to commence another TAP. This new TAP can either be in their SMSF or with a retail provider and while the term can be different to the remaining term of the commuted TAP, the term must still satisfy the rules for a TAP as well as satisfying the minimum pension payment percentages that these pensions are subject to.

The general rule is that where a TAP is rolled over, any asset test exemption the commuted income stream was entitled to will not be transferred to the new TAP, however there are a number of exceptions which can be found on the social security guide here.

Finally, using these rules, it is possible to roll a TAP from a retail provider to an SMSF.

Defined benefit income stream

Defined benefit income streams have been unable to be commenced in SMSFs since 31 December 2005, however there are a number of funds which are still paying out income streams commenced before this date.

A major benefit of these income streams was their Centrelink concessional treatment with those pensions commenced before 20 September 2004 being entitled to a 100% asset test exemption and those commenced after this date and before 20 September 2007 being entitled to a 50% discount.

A member with one of these income streams in their SMSF has a couple of options. They can be rolled to a term allocated pension (TAP) either in their own SMSF or with a retail provider. In either case, the 100% or 50% asset test exemption will be lost.

Prior to 31 December 2015

Otherwise, if they wish to retain the asset test exemption, the member could roll their defined benefit income stream to an equivalent pension with a retail provider.

Previously, where an income stream lost its asset test exemption, Centrelink would recalculate the member's Centrelink entitlements for the previous five years and where the new entitlement was less, a debt would be raised. However, Centrelink will now waive this debt where a new complying pension is purchased, even where the new pension is not entitled to the asset test exemption.

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