**BT** Panorama

# 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

Where an SMSF is paying a pension, the taxation of its investment earnings will depend on:

- Whether the pension is a 'retirement phase' pension.
- The method of calculating exempt current pension income (ECPI). An SMSF may have a choice between the 'segregated' and 'proportionate' method, or may be required to use a particular method.

### Retirement phase pensions

Generally a pension is in retirement phase when a superannuation income stream has no cashing restrictions, which means pension payments and lump sums can be paid with no upper limit. A transition to retirement pension is not classified as a retirement phase pension unless the account holder has also satisfied a full condition of release such as retirement, terminal illness, permanent incapacity or having attained age 65.

Only retirement phase pensions may benefit from tax exempt investment earnings.

### Exempt Current Pension Income

Another important concept is exempt current pension income (ECPI). ECPI is the portion of the earnings of a fund which are exempt from tax in the relevant financial year. The manner in which this amount is calculated depends on whether the segregated or proportionate method is used.

Tax on earnings of assets supporting a pension. 0%

There are two circumstances where one particular method must be used:

- All interests in an SMSF are in retirement phase for the entire financial year, the segregated method must be used.
- The SMSF has disregarded small fund assets – the proportionate method must apply for the full income year. An SMSF will have disregarded small fund assets where:
  - The SMSF has at least one income retirement phase income stream at any time during the income year, and

– A fund member has a total superannuation balance of $1.6 million immediately before the start of the relevant income year,
– That member is receiving a retirement phase pension from any source, and
– The fund is not in 100% retirement phase for the entire financial year.

## Proportionate method

If the proportionate method is chosen or is required to be used, the ECPI figure is obtained from an actuary who usually calculates it by determining the 'average' percentage of assets of the fund supporting retirement phase pensions throughout the income year.

As such, where two members had an interest with similar balances and one was in retirement pension phase for the whole of the year and the other was in accumulation phase, 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 any current year capital losses and also carried forward losses within 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 approximately 50% of the discounted capital gain would need to be included in the assessable income of the fund.

## Segregated method

If the segregated method is used, investment income generated by assets supporting retirement phase pensions will be exempt income. There are a number of ways to segregate a fund but a popular and beneficial one is to segregate some assets which support these pensions within the fund and the remaining assets to any accumulation interests. This means that the earnings on some assets are tax-free but for other assets are fully taxable.

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

Importantly, the period of segregation can be a full year or part of a year. For example, assuming there are no disregarded small fund assets, consider a single member fund who converts their entire balance to pension phase on 1 January within a financial year. The period from 1 January to 30 June will be a period when the fund was segregated as 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 to 31 December, just before the pension commenced and if the fund had a mixture of accumulation and pension assets for that period, an actuarial certificate would be required.

## Capital losses

An interesting consequence of the tax-exemption on the earnings of assets supporting retirement phase income streams 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 be carried forward for use 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 future 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.

# Account Based Pensions

For an individual to commence an account based pension (ABP) within their SMSF, they are required to satisfy the same conditions of release as a member of a public offer fund. While it is possible for an SMSF trust deed to contain governing rules which are more onerous 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 nuances with respect 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 date in the terms and conditions agreed between the member and the trustee that will govern the superannuation income stream. Consequently, 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 becoming aware of 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 above tax ruling stated that an ABP ceases on the death of the member if there is no automatic reversionary beneficiary. This would have resulted in the tax concessions ceasing on the death of the member and any subsequent asset 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 have been paid.

# Available prior to 20 September 2007

## Term Allocated Pensions

Term allocated pensions (TAPs), also known as market linked income streams were available prior to 20 September 2007. The primary benefit of a TAP is that for Centrelink purposes, 50% of asset value is exempt from the assets test.

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 within their SMSF or via 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. Additionally, the relevant minimum pension payment percentage applicable to superannuation income streams must be satisfied.

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 in 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 streams

Defined benefit income streams have not been able 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 prior to 20 September 2007 being entitled to a 50% discount.

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

# Prior to 31 December 2005

Alternatively, if they wish to retain the asset test exemption status of the income stream, the member could roll their defined benefit income stream to an equivalent pension through 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 if the new pension is not entitled to an asset test exemption.

# Since 7 December 2024

Both TAPs and defined benefit income streams held within SMSFs can now be fully commuted during a 5 year grace period. Allowable commutations must occur between 7 December 2024 and 6 December 2029.

This temporary measure only applies to full commutations and it cannot be a partial commutation. In the case of a defined benefit income stream it can include the allocation of the associated reserve that supported the income stream. The resulting capital can be used to commence a new retirement phase income stream subject to the transfer balance cap or withdrawn from super. Income streams that were not sourced from a death benefit may also be held as an accumulation interest.

A reserve allocated for this reason will not count towards any of the member's contribution caps.

If a new retirement phase income stream is commenced it will not have any asset test exemption, meaning the 100% or 50% asset test exemption will be lost.

A legislative instrument has also been registered to ensure that Centrelink will also waive any debt with any full commutations once the instrument commences.

## Disclaimer



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