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Opportunities in a depressed market

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The current financial crisis has many long term SMSF portfolio's down in value over the past 12-18 months. With attention focussing on the negative impact we have highlighted some strategies for a fund transitioning to a pension or maintaining pension and accumulation interests. The newsletter also examines how the exempt pension income deduction is calculated for both segregated and unsegregated current pension assets.

ACCUMULATION INTEREST

Since 1 July 2007 a member's superannuation interest is likely to have been split into tax free and taxable components. The tax free component is the sum of the crystallised segment, calculated and fixed at 1 July 2007, and the contribution segment. This is the sum of all non-taxable contributions and any rolled over tax free component from that date. This amount is fixed and only changes by way of further contribution or withdrawal.

The taxable component is the member interest less the tax free component. While accumulating, earnings are attributable to the taxable component. If the fund has a positive return the taxable component increases but similarly decreases with negative return. If the member's balance drops below the tax free component the entire interest is tax free at that point in time.



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ACCUMULATION INTEREST EXAMPLE

30 June 2007 fund balance of \$1,500,000. Over the next two financial years the fund returns a net growth of 5% followed by net losses of 40% on cost bases.

Event	Balance	Tax free component	Taxable component
Opening Balance	\$1,500,000	\$1,000,000	\$500,000
Yr 1 - \$75,000 gains	\$1,575,000	\$1,000,000	\$575,000
Yr 2 - \$630,000 losses	\$945,000	\$1,000,000	(\$55,000)

TRANSITION TO RETIREMENT CASE STUDY

A possible strategy for members aged 55 or over may be to commence a transition to retirement pension. If they can salary sacrifice to super they can supplement their income via the pension which would be 100% tax free. This strategy may result in a reduced marginal tax rate.

Warning: One issue that clients must be made aware of is that commencing a pension with the entire balance will create a new interest. Any tax free component not recouped will be lost. It is possible to commence a pension with only part of the member balance to retain any tax free balance.

CASE STUDY

A member (aged 55) made a \$1,000,000 non-concessional contribution at 30 June 2007. The tax free component was crystallised at 1 July 2007 at \$1,000,000. No further contributions have been made.

Current accumulation interest is valued at \$600,000. The member's account would look like this:

Tax free component: \$1,000,000
Taxable component: (\$400,000)
Member Balance: \$600,000

If the member commenced a transition to retirement pension for \$600,000 the pension and all future payments from it will be 100% tax free. By taking this action \$400,000 of the tax free component is discarded.

If the member commences a pension for \$550,000 it is still 100% tax free however an accumulation interest would still be retained as follows:

Tax free component: \$450,000 (\$1,000,000 - \$550,000)
Taxable component: (\$400,000)
Member balance: \$50,000

By retaining a balance in the accumulation interest the client can maximise the tax free component by contributing or rolling over additional taxable benefits.



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TRANSITION TO RETIREMENT CASE STUDY (CONT)

In the above example assume the member elects to commence a pension for \$550,000. The fund can pay the member up to \$55,000 (maximum 10%) tax free.

Let's assume the member had a taxable income of \$150,000. They could salary sacrifice \$70,000 reducing the taxable income to \$80,000. The member would pay \$18,000 income tax and \$10,500 tax would be payable by the fund on the contribution. By drawing \$42,000 from the transition to retirement pension the individual receives the same after tax income as before giving a tax saving of \$17,500.

The benefit is that the \$59,500 (contribution after tax) improves the tax free position as shown below (assume no growth for the purposes of the example):

Accumulation balance before contribution	\$50,000
Accumulation balance after contribution:	\$109,500
Tax free component:	\$450,000
Taxable component:	(\$340,500)

In this example the member could contribute/roll-over up to \$340,500 of taxed benefits without creating a taxable component i.e. the accumulation balance is 100% tax free. This is inclusive of fund earnings.

CAPITAL LOSSES

In years of positive growth funds review their capital gains tax position to determine whether any capital losses are available to offset against realised capital gains. This practice can still be considered in a year when returns are negative. Capital losses can be offset only against capital gains and can be carried forward indefinitely. This may provide opportunities for a fund that has segregated current pension assets (entire fund transfers to pension) as the losses realised prior to the pension commencing can be carried forward throughout the term of the pension until no further pension liability exists, e.g. the death of a member.

Capital gains and losses that are realised on segregated current pension assets are ignored for taxation purposes so losses made in those circumstances are not carried forward.

Warning: The ATO issued a tax ruling TR 2008/1 and a taxpayer alert TA 2008/7 on the use of wash sales arrangements. A transaction that involves buying and selling practically the same asset to create a tax deduction may be looked at closely by the ATO.

To show the effect of losses where pensions included requires an explanation of how the exempt pension income deduction is calculated.



EXEMPT CURRENT PENSION INCOME (ECPI)

A fund with a liability to pay a pension is exempt from paying tax on the income earned by the assets that provide for the paying of the pension. There are two methods for determining the ECPI:

- Segregated method
- Unsegregated method

SEGREGATED METHOD

A fund has segregated assets if the trustees identify specific assets for the sole purpose of providing the income to pay the pension. This is relevant when a Fund has pension and accumulation interests.

Once a fund commences paying an account-based pension (inclusive of allocated and market linked) with all of the assets then the segregated method is used as the default.

A fund that uses the segregated method does not require an actuarial certificate as the income supporting the pension is easily identifiable and the ECPI deduction is the amount equal to that income.

Special Income (taxed at 45%), and taxable contributions, are excluded from normal assessable income so do not form part of the ECPI calculation. Segregating assets with special income to a pension does not overwrite this exclusion and special income tax rate still applies.

SEGREGATED METHOD - EXAMPLE

A fund with two members, one in accumulation and one in pension segregate the pension assets at the commencement of the pension.

Accumulation member balance = \$750,000

Account-based pension member balance = \$950,000

The assets supporting the accumulation interest generate income of \$100,000 including \$50,000 of capital gains. The pension assets generate \$150,000 income and have realised capital losses of \$30,000.

The \$150,000 is exempt current pension income. The fund will have assessable income of \$250,000 and a deduction of \$150,000 resulting in a taxable income of \$100,000. The fund can't offset the capital losses from the segregated assets against the \$50,000 gains.



UNSEGREGATED METHOD

Assets that are not nominated to support a pension are considered unsegregated current pension assets. As stated above, the default position is that a fund paying all members a pension with no accumulation account has segregated pension assets. A fund could request an Actuarial Certificate based on the unsegregated method calculation. Most funds do not do this because they prefer not to pay the additional fees required for an actuarial certificate.

The unsegregated method allows a fund to claim a deduction based on the proportion of the fund's pension liabilities divided by the fund's superannuation liability. This is determined by averaging out the pension members balances over the whole year and then dividing it by the total fund balance averaged out over the whole year. A pension commenced part way through the year is averaged out for the period it is paid.

The percentage determined by this sum is applied to the normal assessable income of the fund to determine the ECPI deduction.

UNSEGREGATED METHOD - EXAMPLE

Using the same example as above without segregated assets. The fund has a net assessable position as follows:

Capital gains = \$50,000
 Less capital losses = \$30,000
 Net assessable capital gains = \$20,000
 Total assessable income = \$220,000 (\$150,000 + \$100,000 - \$30,000)

Average pension liability = \$950,000/\$1,700,000 = 55%

Exempt pension income deduction = \$121,000 (55% of \$220,000)

Taxable income = \$89,000

Note: It will not always work out as a positive result by using the unsegregated method. A fund with high income generating assets segregated as pension assets is more likely to benefit from the segregated method.

PENSION OR ACCUMULATION

Capital losses may provide a benefit to members considering moving into pension from accumulation.

Losses realised prior to a pension commencing can be carried throughout the term of the pension if the fund uses the segregated method for ECPI. Additional benefits contributed to a fund, creating an accumulation interest, are likely to reduce the effect of the losses if gains are realised while in an accumulation interest.



Realising losses whilst in accumulation can create a future tax benefit for a fund if the pension liability ceases. Carrying forward losses is likely to have little benefit to an existing pension member. The losses may assist in the reduction of capital gains in the event that the assets need to be sold after the death of the pension member.

TAX LOSSES AND DEDUCTIBLE EXPENSES

Tax losses, not capital losses, must be offset firstly against exempt pension income. Any remaining losses are then offset other against assessable income. Once the assessable income has been reduced to nil remaining tax losses can be carried forward. Fund's entering pension phase or already paying a pension may be able to create a tax loss by claiming a future liability to pay benefit deduction or an anti-detriment deduction under sections 295-470 and 295-485 of the Income Tax Assessment Act 1997 (ITAA 1997) respectively. For more information on these deductions please refer to our previous technical bulletin – 'Tax deductions for death and disability'.

Section 8-1 of the ITAA 1997 allows a fund to claim a deduction on expenses incurred in earning assessable income. Expenses incurred in generating exempt income are not allowable deductions. Any expense associated with segregated pension assets is ignored for taxation purposes. A proportion of investment expenses incurred when using the unsegregated method will be deductible based on the following calculation:

Expenditure x Assessable investment income/total investment income

Assessable investment income is income after deducting exempt pension income.

CONCLUSION

With fund values in a depressed state, there are strategies that allow funds to legitimately minimise tax.

The Government's announcement to half the annual minimum pension requirement was introduced to minimise the need to liquidate assets. This is understandable from a position of preservation however it does provide other opportunities that should be considered.

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