Managing capital gains to maximise exempt income

September 2018

Disregarded small fund assets:

A fund looking to claim ECPI in a financial year has disregarded small fund assets (defined under Section 295.387 of ITAA 1997) in an income year if, at the preceding 30 June, one of its members had a total superannuation balance of at least $1.6 million and a retirement phase interest.

The net capital gains of an SMSF for an income year form part of the fund's assessable income.

How capital gains or losses are taxed will depend on whether any of the fund members are in retirement phase, and the method the fund must use to claim exempt current pension income (ECPI).

Determining the tax exemption on capital gains

For an SMSF with no retirement phase interests (i.e. only accumulation or non-retirement phase TRIS accounts) all net capital gains will be taxable and capital losses can be carried forwards.

Where an SMSF has retirement phase interests we must first determine whether the fund will use the proportionate method, the segregated method or both when claiming ECPI to understand the taxation of any capital gains and losses.

SMSFs solely in retirement phase for the entire income year (account-based pensions, TRIS in retirement phase, market linked pensions) will disregard capital gains and losses under Income Tax Assessment Act 1997 section 118.12. This means that capital losses carried forward from previous years do not need to be offset against current year capital gains realised when solely in retirement phase even if the fund is using the proportionate method for ECPI due to having disregarded small fund assets.

However, where an SMSF has both non-retirement phase and retirement phase accounts in the income year, the taxation of capital gains will depend on the retirement phase status of the fund at the time of sale. It is no longer always the case that the actuarial proportion will apply to the total net capital gains over the income year.

Treatment of gains and losses where the fund had both retirement and non-retirement phase accounts in a year

If the fund had a non-retirement phase account at all times in the income year, or had disregarded small fund assets, then the actuarial exempt income proportion will apply to the net capital gain over the whole income year. If the fund had net capital losses then those can be carried forward. This is the same treatment as practitioners would be familiar with from previous years.

However, if the fund did not have disregarded small fund assets and had periods of the year where assets were solely supporting retirement phase accounts then the fund would be deemed to have segregated current pension assets in those periods.

For a fund in this situation:

- any capital gains realised when the fund had a non-retirement phase interest would have the actuarial exempt income proportion apply, any losses could be carried forward, and
- any gains or losses received when the fund was deemed to be segregated would be disregarded.

This impacts the taxation of any capital gains in two ways:

- The actuarial exempt income proportion will be lower than would have been the case in previous years because the assets deemed to be segregated pension assets are excluded from the actuarial calculation; and
- The timing of capital gains and losses being realised becomes important.

Selling assets where the fund has deemed segregation

A fund cannot choose to use the proportionate or segregated method based on what will give the best tax outcome. How capital gains are taxed depends on the decisions made by trustees before the start of the income year and the transaction made during it.

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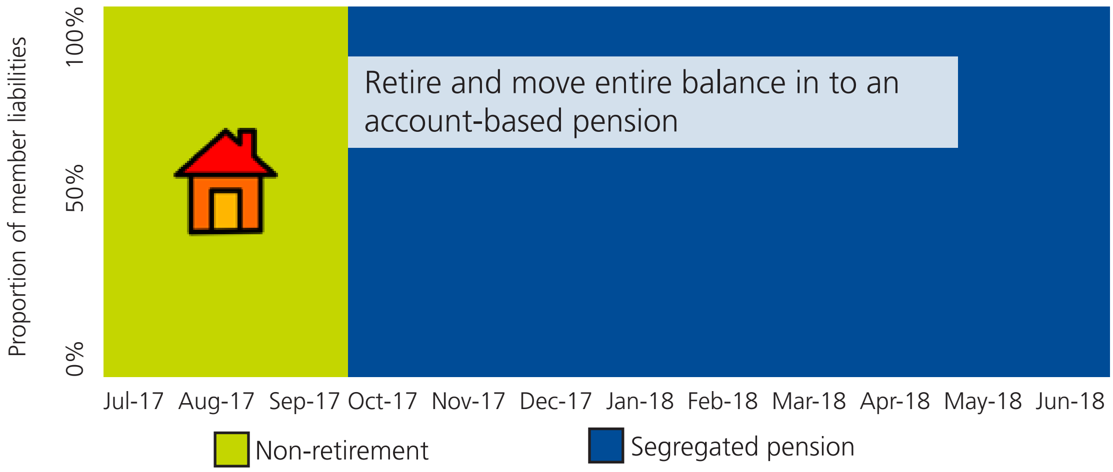
This impacts the taxation of any capital gains in two ways:

- A single member SMSF with Cameron who had $1,500,000 in accumulation phase at 1 July 2017
- Cameron retired in October 2017 and commenced an account-based pension with his accumulated savings
- Cameron drew only the minimum pension required
- The fund owned an investment property and to improve the liquidity in the fund was looking to sell it in the 2017-18 year

In prior income years it would not have mattered when Cameron sold the investment property in the income year as the fund could have obtained an actuarial certificate and the exempt income proportion would apply to that net capital gain. The capital gain would be around 75% tax exempt.

However, from the 2017-18 income year we need to account for deemed segregation. When Cameron retires and moves his balance into a pension the fund assets at that time will be solely supporting retirement phase accounts. The fund's assets would be deemed to be segregated current pension assets.

The fund's liabilities over the income year would be as shown in the below chart.



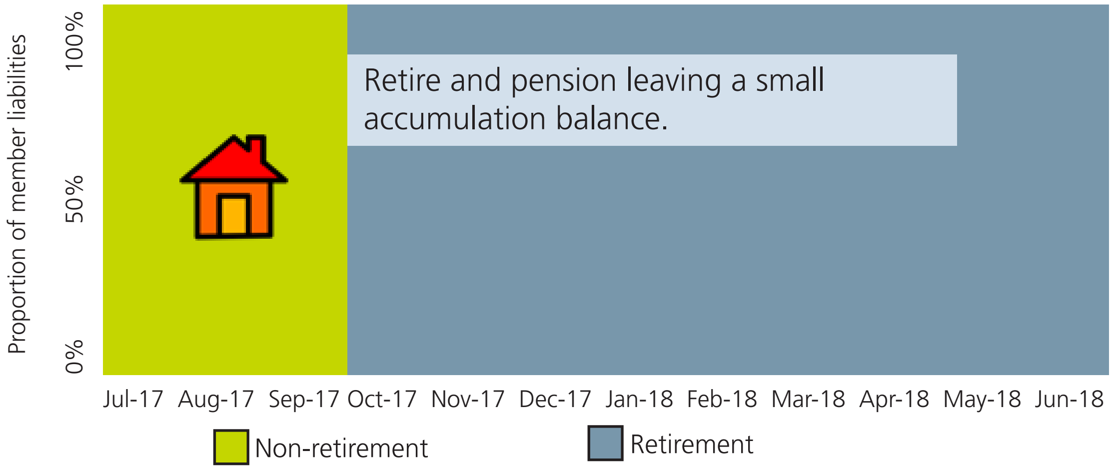
This highlights that the fund was entirely in accumulation phase and moved to being entirely in retirement phase once Cameron retired. The fund would be deemed as having segregated current pension assets once he retires in October.

If Cameron had gone ahead and sold his property early in the income year before he retired then the capital gain would be taxed under the proportionate method excluding any segregated pension assets. In this case, once we exclude the segregated pension assets (in blue above) the fund has no other retirement phase accounts and will have an exempt income proportion of 0%. The capital gain would be entirely taxable.

Cameron could have had a better outcome by understanding the new rules and planning ahead.

Once he sold the asset for a gain prior to retirement, he could have made a decision to commence his account-based pension in October with less than his entire balance. If he instead left, say, $10 in accumulation this would means his fund did not move to be solely in retirement phase. The fund must use the proportionate method and obtain an actuarial certificate to claim the exempt income on the capital gain.

The chart below highlights the fund liabilities under this strategy.



With a small accumulation balance maintained the actuarial exempt income proportion of 75% now does apply to the capital gain received prior to Cameron retiring in October. A significant tax saving.

On the other hand if Cameron reached retirement in October and had not yet sold a property. It would be more advantageous to move his entire balance into pension. Then when the property was sold later in the year the capital gain would be realised in a deemed segregated period and would be disregarded, 100% tax exempt.

This strategic thinking also importantly applies to capital losses. If Cameron had sold an asset at a capital loss after retirement when he was solely in pension then the loss would be disregarded. However, if Cameron had an accumulation account at the time the loss was received then the loss would fall under the proportionate method and could be carried forward.

Conclusion

It can be seen that SMSF practitioners and their clients must now understand the implications of ECPI when making investment decisions about fund assets. ECPI is no longer a matter solely for consideration in arrears when completing the tax return. In order to better manage the tax outcomes a trustee must be more strategic and make plans in advance of assets being sold.

Phone: 1800 203 123
act@accurium.com.au
www.accurium.com.au