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Technical Bulletin: Segregating Assets in SMSFs

SMSFs can use segregation to separate the assets of the fund for several reasons. It can be done to separate the assets between accumulation phase interests and retirement phase interests for the purposes of determining the income of the fund that is exempt from tax. Alternatively, it can be used to separate member's investment portfolios for any number of reasons. This bulletin will look to identify the main reasons for segregating fund assets, what circumstances prevent segregation being used, how segregation is implemented from a practical administrative perspective and identify the alternative to calculating the income tax exemption where segregation is either not preferable or not allowed under the legislation.

Types of segregation

For simplicity purposes we have broken segregation into two distinct levels, fund and member. It should be noted, and is highlighted, that even at these levels there are still multiple variations for what segregation might look like.

Fund Level – The most common type of segregation, and that which leads to the most misunderstanding and has historically been the subject of misuse is asset segregation at fund level, for the purposes of claiming exempt income. At this level, the assets of the fund are traditionally segregated by accumulation phase interests and retirement phase interests. Where hybrid funds exist, pension and accumulation, assets are identified and specifically allocated to an accumulation phase pool and a retirement phase pool. A key to this type of segregation is to ensure that the assets are appropriate to the pool they are allocated to i.e. retirement phase assets will need have higher income and/or be more liquid to meet pension payments compared to accumulation phase assets which can potentially be more long-term growth assets.

Beyond tax exemption, another reason why assets may be segregated at the fund level is to distinguish between Australian funds and foreign sourced transfers. Whilst not mandatory, if a fund has received transfers from the United Kingdom it may wish to segregate those assets for ease of future reporting obligations and to satisfy any UK asset restrictions, whilst not compromising what investments are undertaken with Australian sourced contributions.

Member Level – Fund level segregation may often look like member level segregation because one member is in retirement phase and another is in accumulation phase, however, member level segregation is distinct from fund level as it usually is representative of investment objectives rather than tax exemption. At the member level the assets are segregated by member accounts but may also be broken down further into specific member interests such as pension v accumulation interest. Ultimately, each member has their own pool of investments tied to their overall member balance. This may be the result of their investment preferences, investment horizon and risk tolerance being different to the other members of the fund.

Reasons to segregate

Whilst not exhaustive, the following reasons are a snapshot of why funds and members may choose to segregate:

- Segregating at the fund level can be useful for funds with members in different life stages with different investment objectives/requirements and income needs.

- Segregation at the member level can be useful for members with different investment preferences and risk profiles. They may simply want to keep their finances separate albeit within the same SMSF.
- It can be for tax purposes for funds with accumulation phase accounts that are also paying retirement phase income streams to enable them to determine the exempt current pension income without needing an actuarial certificate.

It's important to note that running multiple portfolios and bank accounts requires a greater attention to detail within a fund. It creates more administration work and takes more time for everyone involved so it's important to ensure that the benefits of segregation outweigh the costs and are worthwhile for the specific fund.

Inability to segregate – disregarded small fund assets

Before going into how segregation works in an SMSF, it is important to understand there are restrictions on whether an SMSF can use segregation for tax purposes. Prior to the introduction of the transfer balance cap from 1 July 2017 there was no limit on how much could be held in retirement phase pension accounts. As a result, members could have as much as possible in retirement phase generating tax free income and ultimately segregation was much more susceptible to manipulation for tax purposes, despite a consistent message from the ATO about undertaking dubious practices.

There are now instances where segregation for tax purposes is no longer allowed, this occurs when an SMSF (or a Small APRA Fund) has 'disregarded small fund assets'. Disregarded small fund assets apply in the following circumstances where an SMSF is paying a retirement phase income stream:

- A (any) member of the SMSF has a total superannuation balance of $1.6 million or more as at 30th June of the prior year (in every fund that they are a member, not just the SMSF); AND
- That member(s) with more than $1.6 million is in receipt of a retirement phase income stream from any super fund

Example – Disregarded small fund assets

The Double S SMSF has the following members during the 2020/21 financial year:
Simon has a retirement phase pension with a balance of $1 million at 30 June 2020
Sharon has an accumulation interest with a balance of $500,000 at 30 June 2020

Sharon is also in receipt of a capped defined benefit income stream from her employment with the Government with an annual income of $100,000. Her special value for transfer balance cap purposes is $1,600,000.

Due to Sharon's total super balance exceeding $1.6m the Double S SMSF is unable to segregate for tax purposes and must obtain an actuarial certificate each year to determine the tax exempt earning percentage.

The fund can still segregate at the member level and allocate the income on that basis, however tax is determined at the fund level.

Currently an SMSF with 'disregarded small fund assets' can't have segregated current pension assets even in situations where the fund is 100% in retirement phase.

Example – Disregarded small fund assets – 100% pension

The Lucky Star SMSF had the following members during the 2019/20 financial year:
Lucy (63) has a retirement phase pension with a balance of $800,000 at 30 June 2019
Sean (65) has a retirement phase pension with a balance of $1.5 million at 30 June 2019

Sean has $150,000 in an accumulation account in an Industry Fund where he holds his life insurance policy.

Sean's total super balance exceeds $1.6m so the Lucky Star SMSF is unable to segregate for tax purposes and must obtain an actuarial certificate each year to determine the tax exempt earning percentage, despite 100% of the fund assets supporting retirement phase income streams and the certificate stating that 100% exemption applies.

The Government have proposed to amend this current feature ensuring that funds who are 100% in retirement phase will be able to elect to use the segregated measure. If legislated this measure will take effect from 1 July 2021.

Based on the above examples, in opting to use segregation for tax purposes, it is important that SMSF service providers and trustees are aware of any other external super balances a member may have to ensure the total superannuation balance limit is adhered to. As it stands, segregation cannot be used to find opportunities to manipulate the tax liability of SMSFs with high balances as was previously the case; and members cannot get around the total superannuation balance limit by having multiple funds/pensions.

It's important to reiterate that segregating assets for tax purposes compared to investment purposes are two separate matters. Where a fund may not be eligible to use segregation for tax purposes they may still want to segregate for investment purposes so that specific income is allocated to certain pools/members.

How does segregation work for income tax purposes?

As identified, earnings on assets supporting retirement phase income streams are generally tax free. This is known as exempt current pension income (ECPI). Since the introduction of the transfer balance cap there are less funds that are 100% in retirement phase and who now need to consider what method they will use to calculate the exempt current pension income (ECPI) of their fund each year.

The segregated method is one such method to calculate the amount of ECPI an SMSF can claim. All income from segregated current pension assets is ECPI. ECPI does not include either assessable contributions or non-arm's length income (NALI) received by the fund. Segregated current pension assets are assets that are identifiable and have as their sole purpose supporting the payment of retirement phase income streams.

When a capital gains tax event takes place in relation to a segregated current pension asset, both capital gains and capital losses are disregarded.

Deemed or elected segregation

Where all interests in an SMSF are retirement phase income streams, then all fund assets are held solely to support retirement phase income streams. In this situation 100% of the fund is in retirement phase. All of the fund's assets are considered to be segregated current pension assets, unless they are disregarded small fund assets, the ATO have determined that these assets are deemed to be segregated. As stated, there are plans to rectify the anomaly linked to disregarded small fund assets.

Deemed segregation arises where a fund has not actively made a decision to operate on a segregated basis, but they are exclusively paying retirement phase income streams. In this situated they must claim ECPI under the segregated method.

Example – Deemed segregation

Let's go back to the Lucky Star SMSF. Sean no longer has a need for his insurance so he closed his industry fund and he took the $150,000 as a lump sum benefit.

Returns were fairly flat resulting in a total superannuation balance as follows:

Lucy still had a retirement phase pension with a balance of $805,000 at 30 June 2020
Sean had a retirement phase pension with a balance of $1.510 million at 30 June 2020

The ATO deem that the Lucky Star SMSF is 100% in retirement phase and must use the segregated method because they no longer have a disregarded small fund asset issue.

However, under the current rules, a fund may need to switch methods of calculating ECPI to the proportionate/unsegregated (Actuarial) method during the year where there are periods where both retirement phase income streams and accumulation phase interests are held. As a result, deemed (or forced) segregation can create administrative issues for a fund having to use two methods for calculating the tax exemption for one year.

Example – Changing circumstances

Sean determines to contribute $100,000, remaining from his previous withdrawal, to Lucy in the Lucky Star SMSF. The contribution occurs on 1 February 2021.

In this instance the fund will use the segregated method from 1 July 2020 to 31 January 2021 and then the Actuarial method from 1 February 2021 until 30 June, if Lucy retains the amount in an accumulation interest.

A quirk in the segregation rules would allow the above fund to "segregate" the $100,000 as an accumulation asset however this would need to be prospective not retrospective.

Similarly to the proposed changes around disregarded small fund assets, the Government are also proposing that a fund in 100% retirement phase will be able to elect which method they use which would allow funds in the above situation where they will move from 100% retirement phase to a hybrid fund to elect to use the actuarial method for the whole year.

Unlike deemed segregation, where an SMSF pays a retirement phase income stream, also has accumulation interests and doesn't have disregarded small fund assets within a financial year, then they will have the option to calculate ECPI under the segregated method or actuarial method. In contrast to deemed segregation, elected segregation arises where an SMSF is eligible to use segregation and the members actively document their decision to use this method. It should be noted that as this type of segregation is elective it should be based on pre-planning and trustees should not try to implement retrospectively. Where they have made this decision, they should ultimately follow the necessary steps as outlined below to implement it.

Before we get to the steps required to segregate, it's important to have clarity on bank accounts and fund expenses.

Do you need to maintain separate bank accounts for each asset pool?

Ideally it is easier to maintain segregation when each asset pool has a distinct separate bank account to receive income and make payments from. However, the ATO have confirmed, via Taxation Determination 2014/7 ***'Income tax: in what circumstances is a bank account of a complying superannuation fund a segregated current pension asset under section 295-385 of the Income Tax Assessment Act 1997?'*** that a fund may either

maintain a separate bank account for each pool or have notional subaccounts in order to maintain segregation for their fund.

Where a bank account is supporting both retirement phase pension accounts and accumulation accounts and the SMSF wants to treat part of the bank account as a segregated pension asset, then the SMSF must maintain notional sub-accounts for the components of the bank account. This involves either formal sub-accounts maintained by banks or informal sub-accounts maintained by trustees keeping appropriate accounting records so that the balance of each sub-account can be tracked and identified at any point in time.

If informal sub-accounts are being used, it will be necessary to apportion some expenses to maintain segregation which will involve transferring between bank accounts within a reasonable time (whilst no specific timeframe is given in the tax determination, a reasonable timeframe should be contemplated as "immediately" to avoid the unnecessary calculation of interest). Where there is a time lapse there may be interest earned on amounts that don't relate to the segregated current pension asset and this needs to be transferred where necessary also within a reasonable time period to maintain segregation.

How are expenses treated?

Where an SMSF incurs expenses in earning ECPI, they are generally not deductible in the annual return and are therefore not included. Expenses incurred in generating non-assessable, non-exempt income or expenses that are considered to be of a capital, private or domestic nature are not allowable deductions for tax purposes.

Where an expense is incurred and it relates to both ECPI and assessable income, then it must be apportioned. The portion of the expense that relates to the assessable income is the amount that can be claimed as a tax deduction in the annual return. Refer to our fact sheet on apportioning SMSF expenses for examples of some of the methods that can be used to apportion expenses.

Where an SMSF is 100% in retirement phase, the expenses are generally not deductible as they relate to generating ECPI. However, some expenses are 100% deductible regardless of what income they relate to (e.g. supervisory levy and death/disability premiums).

How to implement in an SMSF?

Once it has been determined that segregation is appropriate to use and there are no restrictions on the fund proceeding, the following steps can be followed to implement it:

Step 1. For any SMSF decision, the first step is generally to check the trust deed. We need to ensure there is nothing specifically preventing segregation in the SMSF.
Step 2. Check the SMSF assets and ensure they can be appropriately split at the fund or member level depending on what approach is being used. If there is a large bulky asset that cannot be split across the fund/member pools, then segregation may not be possible (such as property – you cannot segregate part of an asset).
Step 3. List each asset and which pool it is allocated to ensure all assets are accounted for and make up the necessary pool balance.
Step 4. Review and update the fund's investment strategy to ensure it is appropriate to the segregation method and each member's preferences.
Step 5. Ensure the accounting records are revised to reflect the segregated pools and make sure any separate bank accounts are established where required. The assets must be clearly identified and there must be a clear relationship between the assets and the member's account.

It's not all about tax

If a fund is contemplating segregating assets for other purposes, such as member directed investment strategies or tracking UK based benefits, then this clearly needs to be documented and monitored on an ongoing basis.

A fund can maintain segregation for investment strategy purposes and not adopt a segregation strategy for tax purpose i.e. they can use the actuarial method for determining exempt income.

What is the alternative?

As noted throughout the bulletin, the alternative to segregation in an SMSF is to have unsegregated assets and use a proportionate approach, referred throughout as the Actuarial method. Under this approach there are no specific assets supporting the retirement phase income streams. In determining the income tax exemption applicable to the fund, where there are accumulation and retirement phase interests during the year, an actuarial certificate will be required. An actuary undertakes the necessary calculations to determine the exempt proportion of the fund's income that is ECPI.

Where a fund chooses not to segregate or is prohibited from segregating due to disregarded small fund assets, the unsegregated approach does offer some benefits to consider as follows:

- Simplicity as all assets are pooled
- Simplicity can lead to easier administration, less time spent and lower costs involved
- Capital losses can be preserved and can be carried forward and used in future. This may be of benefit in the long term if the dependants of the current members join the fund. This is in contrast to segregated funds where all capital losses on segregated current pension assets are ignored.
- Pooling the member accounts may give the SMSF greater investment opportunities for larger assets. Where bulky assets are held such as property they may not be able to be segregated between member accounts and this is not an issue under the unsegregated method.

We have a Fact Sheet that outlines how the unsegregated approach works. Click here to view.

Conclusion

Where an SMSF is intending to use segregation for claiming exempt current pension income and calculating their income tax, they will need to ensure they are eligible each year based on the disregarded small fund asset rules. Without proper consideration of the requirements the tax outcome and ultimately the additional expense may be undesirable. The choice to use segregation should be justifiable and like most things proper prospective planning is key.

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