



TECHNICAL UPDATE

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Account-based Pensions – Consider Your Options

Paying an Account based pension from a SMSF is a relatively simple task for Trustees, however there are a number of events that add complexity which if not handled correctly can create problems.

This bulletin addresses the issues associated with taking a lump sum from a pension via a commutation and the inevitable issue of what happens to a pension when the member dies.

Whilst Superannuation and Income Tax legislation use different terminology when referring to pensions, we have maintained consistency by using the terms pension and payment.

SUPERANNUATION INTERESTS

The tax free and taxable components, introduced on 1 July 2007, are fixed as percentages at the time of commencing a pension and apply to all pension payments and lump sums resulting from a commutation up to and including the payment of a death benefit, from that interest. Where the pension interest is paid as a lump sum to a non-dependant adult child the beneficiary will at least have an idea as to the percentage of the benefit that will be taxable.

All benefit payments received from age 60 are not assessable income for the member.

The taxable components of the pension and the age of the member will be determining factors when addressing the issues of paying lump sums and what action to take when a member dies.

“Pensioners over the age of 60 have the same taxation treatment whether a benefit is paid as a pension or a lump sum”

LUMP SUM WITHDRAWALS

As pensioners over the age of 60 have the same taxation treatment whether a benefit is paid as a pension or a lump sum it will generally be appropriate to consider all payments as pension payments. However it can be very different for people under the age of 60 or those in receipt of the Age Pension.

MEMBERS 55 - 59

Pension payments for members over 55 but under 60 are taxable at marginal tax rates less a 15% rebate. A lump sum payment is taxed according to whether a member has utilised their Superannuation Lump Sum Low Rate Threshold (\$160,000) which is the amount of the Taxable Component up to which a member can draw without incurring a taxation liability. Amounts in excess of this limit are taxed at 15% plus Medicare.

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It can therefore be assumed that any pensioner under the age of 60 in receipt of income greater than \$37,000 (the income level where marginal tax increases from 15% to 30%) could benefit from taking a lump sum rather than taking a pension payment.

MEMBERS ELECTION

The member must elect prior to the payment being made that it is not a pension payment but rather a lump sum which will count towards the member satisfying their minimum pension requirement and the fund still being entitled to a deduction on the income supporting the pension.

Example Lump Sum v Pension

Mary Jones is 58 years old with a minimum pension of \$50,000. This example assumes no other income and ignores Medicare.

Pension Calculation

Drawing
\$50,000

Tax
 $\$37,000 \times (15\% - 15\% \text{ rebate}) = \0
 $+ \$13,000 \times (30\% - 15\% \text{ rebate}) = \$1,950$

Lump Sum Calculation

Drawing
\$50,000

Tax
 $\$50,000 \times 0\% = \0

Mary will pay \$1,950 more tax if she receives her income as a pension rather than as a lump sum (assuming she has not used their Low Rate Threshold).

calculation results in a deductible amount which reduces the assessable income, much like the tax free component of a pension reduces the assessable income for taxation purposes.

COMMUTATIONS – PARTIAL OR FULL

The above scenarios result in a member meeting their minimum pension requirement. There are instances where a member commutes their pensions for other purposes which may be to add additional contributions and restart the pension or to stop the pension. When a member commutes a pension a pro-rata minimum must be paid up to and including the day of commutation. This means if a member elects to commute a pension on 1 July the Fund has an obligation to pay 1 day's pension to that member. As a practical guidance to those wanting to merge existing pensions or to stop an existing pension and add contributions and start again, 30 June is a more appropriate Commutation date with a new commencement date of 1 July.

Example – Commutation 1 July

Robert Smith is aged 65 and has a minimum pension requirement of 5%. His account balance is \$1,000,000, therefore his annual minimum requirement is \$50,000.

Pro-rata Calculation

$\$50,000 \times \frac{1 \text{ Day}}{365 \text{ Days}} = \$137 \text{ income requirement}$

DEATH OF A PENSIONER

The death of a member in receipt of a pension can result in unexpected Capital Gains Tax being payable by the Fund if the assets must be sold to pay the Death Benefit to the Estate or a beneficiary. If the pension recipient has a spouse (or dependant) it could be considered appropriate to commence a reversionary pension as the pension will continue to be paid when the member dies allowing time if necessary for the Fund to sell the assets in the event the beneficiary wants to take a lump sum. This strategy will remove the Capital Gains issue.

Alternatively a member can leave the decision to the Trustee giving them the power to pay a benefit as they deem appropriate either in accordance with a binding death benefit nomination or at their discretion if no binding nomination exists. This could still result in a pension reverting to a spouse which can achieve the same result as a reversionary pension but allows for the benefit to be directed elsewhere if required.

MEMBERS IN RECEIPT OF AGE PENSION

The same strategy to that expressed above can be adopted by members in receipt of the Age Pension. A person's eligibility to the Age Pension (other than there age) is determined by the Asset Test and the Income Test.

A Lump Sum Benefit is not counted in the Income Test. Therefore if a member in receipt of a pension requires more income they could consider taking this as a lump sum to avoid it counting against the Income Test.

This may impact future Age Pension entitlements as lump sums are reported to Centrelink who calculate how much of an individual's income is considered a return of capital (original purchase price). This

Both strategies should be given careful consideration before implementation. It is possible in the current SMSF environment, where many members have multiple pension interests, that a member may end up with a combination of strategies that apply to the different interests within their Fund as each pension interest is treated separately.

Outlined below are important issues that all Trustees and members should be aware of that may help with the decision making process.

SIS DEPENDANTS

A pension can only revert to a dependant of the deceased in accordance with SIS Regulations. A dependant for these purposes primarily includes the deceased's current spouse, children under the age of 18, a person in an interdependent relationship or someone who is considered financially dependent. A Child of the deceased who is financially dependent can only receive a pension up until age 25 unless they are permanently disabled.

The beneficiary must be a dependant at the time of death, it is not satisfactory that they were dependent at the time the original pension commences, or an original nomination was made.

INCOME REQUIREMENTS

There are different payment and calculation obligations applicable to reversionary pensions versus a pension payable at the discretion of the Trustee.

A pension that automatically reverts to a beneficiary is a continuation of an existing pension. There is an annual income requirement, calculated at 1 July each year that must be paid by 30 June regardless of when the member died. The income requirement is based on the original recipient's age at 1 July prior to their death. It will be recalculated at the following 1 July based on the reversionary beneficiaries age at that time.

A pension that does not automatically revert but the Trustee elects to pay to a beneficiary is, for the purposes of income requirements, a new pension. The Trustee must recalculate the pension at the date the pension reverts to the beneficiary and a pro-rata pension must be paid for the remainder of the year based on the beneficiaries' age. As the original pension is effectively commuted there is no requirement for the deceased to have been paid a pro-rata minimum from 1 July until the date of death.

Example – Reversionary Pension

David Brown, aged 75, is in receipt of an account-based pension valued at \$600,000 at 1 July.

The annual minimum pension requirement is \$36,000 (6% x \$600,000). If David dies on 31 May and the pension reverts to his spouse Doris, aged 63, the Trustee is still required to pay the full \$36,000 prior to 30 June.

A Discretionary Pension is where the beneficiary elects to take benefit as a pension.

Example – Discretionary Pension

From the above example let's assume David's pension was not established as reversionary.

The Trustee, in consultation with the beneficiary, determines to continue the benefit as an account-based pension to Doris from 1 June.

There is no pro-rata minimum requirement to be paid to member up until 31 May but due to her age Doris's minimum pension would be calculated based on 4% of the account balance at 31 May.

As this new pension commences on or after 1 June there is no requirement for the Trustee to pay the minimum for that year. At 1 July the Trustee will calculate the minimum for the spouse based on 4% of the account balance at 30 June.

BINDING NATURE OF A PENSION

A reversionary pension is a binding contractual arrangement built into the terms of the pension contract so it overrides any existing binding death benefit nomination a member has made that contradicts this arrangement. This position has been confirmed by the ATO as Regulator of SMSFs. Once a pension has reverted to a member's beneficiary the interest is no longer attributable to the deceased member. In the event of remarriages and children from previous relationships this means a member can't elect to revert a pension to their spouse and then when their spouse dies direct the payment to the children. The spouse can make a nomination to pay their benefit to the children if they satisfy the definition of a SIS dependant

There is no best case scenario to fit the needs of all individuals. Rather there is a best case scenario appropriate to each individual based on family history, family future and the potential tax liability associated with paying certain benefits out of a SMSF.

DECISION MAKING

The decision to provide a reversionary pension should be determined by the member based on who is going to receive the pension or proceeds from a pension when the member dies.

If the spouse is to receive 100% of the benefit on death, making a pension reversionary makes good sense. It removes the need for the spouse to make hasty decisions allowing up to at least 6 months after the death of the member to elect to take a lump sum and still receive favourable tax treatment. Reverting the pension won't jeopardise the exempt pension income status as the Fund retains its liability to pay a pension allowing for careful planning to remove Capital Gains if the intention is to pay the benefit out. It is worth noting that if the members of the Fund (spouses) are also each other's Executors they could give the Trustee discretion as how the benefit is to be paid as there is likely to be a clear understanding of who is to receive the benefit.

If however a member intends part of their benefit to go to non-dependent adult children or other beneficiaries, making a pension reversionary or giving the Trustee discretion may not be appropriate as reversionary pensions result in a member's benefit changing ownership once it transfers, leaving limited options for non-dependent adult children unless they have an interdependent relationship or are financially dependent on the surviving non-lineal parent.

Similarly leaving it to the Trustee's discretion can create problems if the Legal Personal Representative of the deceased has a vested interest as a beneficiary and pays a benefit according to their interest rather than the member's intent. It may be prudent for a member to provide the Trustees with a binding death benefit nomination or specify in the Trust Deed how benefits are to be paid on their death. In the event a member takes either of these alternatives it is recommended that they seek appropriate advice.

A reversionary pension gives certainty to members and removes the additional administrative burden of recalculating pensions to ensure minimum pensions are met. They do however restrict how a benefit is paid so are not appropriate in all circumstances. A non-reversionary pension potentially provides more flexibility on death but may compromise the exempt pension income status of the pension on the death of the pensioner.

Finally if a member commenced a pension that wasn't reversionary they can always commute and recommence a reversionary pension without affecting the existing tax free/taxable components if done correctly.

CONCLUSION

There are many practicalities to be considered when commencing or stopping a pension and. There are a number of calculations that need to be performed in order for a fund to comply with its pension obligations so whilst the concept of paying a pension to a member can be quite simple, there are events that will affect the simplicity of the transactions.

Members should consider how they want their Estate to be distributed when they commence a pension as poor decision making can lead to problems once the member has died and can't clarify their intent to the Trustees.

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