

## COMPLYING PENSIONS IN SMSFs – CALL TO ACTION

The ability to commence most types of Complying Pensions in an SMSF ceased on 31 December 2005. However, those Complying Pensions could continue to be paid. The fact some SMSFs are still paying Complying Pensions gives rise to possible need for considerations by Trustees.

**The ATO's release of its SMSF Regulator's Bulletin SMSFRB 2018/1, concerning the use of reserves by SMSFs, provides a timely reminder of the need to consider taking action on Complying Pensions.**

### SMSFRB 2018/1

The SMSF Regulator's Bulletin provides the ATO's views on the use of reserves by SMSFs.

In short, the only form<sup>1</sup> of 'reserve' which the ATO considers to be acceptable is a reserve for complying pensions.

### Types of Complying Pensions

The main Complying Pensions, and the SIS Reg under which they are paid, are:

Type	Reg
Lifetime	1.06(2)
Life Expectancy	1.06(7)
Market Linked	1.06(8)

A Market Linked Pension is unlikely to have a reserve, as the pension range for a year is determined by the value of its underlying assets (account base) each year. As Lifetime and Life Expectancy Pensions need to

meet solvency requirements, they hold reserves to meet those requirements.

### Call to Action

Having determined that a Complying Pension reserve is not on the ATO banned list, we need to consider a much more pressing issue – what will happen to the assets supporting the pension on the death of the pensioner (or even earlier)?

### It is Not Their Money!

When the Lifetime and Life Expectancy Pensions were commenced, the member effectively exchanged their balance (or part of it) in the Fund for the right to receive a pension, either for the term of their life expectancy or for the remainder of their life.

In other words, the funds supporting the pensions do not belong to the members and, on completion of the term of life expectancy or the death of the pensioner<sup>2</sup>, will belong to the fund (and be held in a pension reserve).

The ATO, in SMSFRB 2018/1, confirms that position at paragraphs 24 & 25 by stating:

*"Trustees should also be aware of ... ATO ID 2015/22... The pension account and the pension reserve account are taken together to represent a 'reserve' for the purposes of regulation 291-25.01 of the ITAR 1997. However, the amounts in these accounts comprise an amount available to the trustee, not the member, to satisfy the trustee's liability to pay the complying lifetime pension."*

Therefore, to overcome the potential of the Trustee having to deal with a pension reserve after the pension has ceased, consideration may need to be given to commuting the pension during the lifetime of the pensioner.

As the Lifetime and Life Expectancy Pensions in SMSFs have been running for more than 13 years (i.e. commenced pre-December 2005) and, considering the member's age when the pensions are likely to have commenced, that consideration may be an urgent matter.

### What Happens to the Funds?

To answer that question, let's consider Jenny who commenced

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a 15 year Life Expectancy pension in 2004.

Although Jenny's life expectancy in 2004 was 15 years, she is fit and healthy and looking forward to many more years of life.

Jenny is also expecting to receive the remaining funds supporting her pension once the term expires in 2019.

Unfortunately, the remaining funds will not automatically be paid to Jenny **as they are not hers**. They belong to the Trustee and are to be held in a reserve in the Fund.

Sure, the Trustee could pay Jenny the remaining amount but it would represent an allocation from a reserve which would, potentially, result in Jenny being deemed to have exceeded the concessional contributions cap in the year of payment.

There is scope to allocate funds from a reserve, so all may not be lost for Jenny, but there are limits on the amount which may be allocated each year. The two main limitations are:

- the amount allocated is distributed proportionately to all members at up to 5% of their interest in the fund (remembering the money in the reserve is not Jenny's 'interest' in the Fund – she may not even have a balance); or
- the amount allocated will be measured against the

concessional contributions cap of the relevant member.

Jenny is not likely, because of her age, to have made concessional contributions in the year of payment, so she could receive allocations of \$25,000 per annum until the reserve is exhausted.

How soon that occurs will of course depend on the total amount remaining but, unless the amount was minimal, it could take some years to extinguish the reserve, without incurring excess contributions tax<sup>3</sup>.

### Available Options

Leaving action until the term expires (Life Expectancy) or the death of the pensioner may preclude any ability to restructure the pension.

With a few exceptions, complying pensions are generally non-commutable.

One of those exceptions is when the proceeds from the commutation<sup>4</sup> are applied in the commencement of another complying pension.

If the pension is to be paid from the SMSF, the only form of complying pension able to be paid is a Market Linked Pension.

### Market Linked Pension

A Market Linked Pension, although a complying pension, operates in similar fashion to an Account Based Pension, in that:

- the annual pension amount is based on the value of the underlying assets at the start of the year; and
- on death, the remaining balance in the pension account can form part of the member's death benefits.

The latter point is a common reason why Trustees choose to commute complying Life Expectancy or Lifetime Pensions and use the funds from that commutation to commence a Market Linked Pension.

### Transfer Balance Cap Issues

Defined Benefit Pensions received different treatment under the Superannuation Reform legislation which mainly took effect from 1 July 2017, when compared to Account Based Pensions.

The Superannuation Reform legislation, mainly effective from 1 July 2017, introduced a new term which covers those pensions - Capped Defined Benefit Income Streams.

As the funds supporting Life Expectancy, Lifetime and Market Linked Pensions could not be

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commuted to the Accumulation Account of the individual members, different treatment was required so as not to force the member to breach the Transfer Balance Cap.

For Life Expectancy, Lifetime and Market Linked Pensions held before 1 July 2017, they will be deemed not to have exceeded the Transfer Balance Cap but different taxation provisions apply to the pensions paid.

For Market Linked Pensions commenced on or after 1 July 2017, the standard Transfer Balance Cap rules apply, which effectively limits the ability to:

- commute Life Expectancy and Lifetime pensions; and
- commence a Market Linked Pension,

to those instances where the underlying capital would enable the total of the member's Transfer Balance Account to remain within the Transfer Balance Cap - currently \$1,600,000.

### Market Linked to Market Linked

Whilst we have focused so far on the commutation of Life Expectancy and Lifetime Pensions within the SMSF, so as to commence a Market Linked Pension, another aspect worthy

of consideration is the commutation of an existing Market Linked Pension to commence a new Market Linked Pension.

As mentioned above, payments from Market Linked Pensions held before 1 July 2017 attract different tax treatment.

Additionally, a 'special value' is applied to determine the value of those pensions, and that value is then recorded in the member's Transfer Balance Account.

That special value is arrived at by multiplying the annualised pension payment by the remaining term, in years, of the pension as can be seen in the following example:

- Ann, born September 1946, has been receiving payments from a Market Linked Pension for some years;
- the remaining term of her Market Linked Pension is 18 years;
- the underlying value of the assets supporting the Market Linked Pension at 30 June 2017 was \$1,400,000;
- her minimum pension for the 2017/18 year was \$95,530, meaning she did not trigger the tax provisions which apply to pension amounts over \$100,000;

- the special value of her Market Linked Pension was therefore \$1,719,550 (\$95,530 x 18);
- although her Transfer Balance Cap is \$1,600,000, she cannot exceed the cap by virtue of the fact she is receiving a Capped Defined Benefit Income Stream.

On that basis, there does not appear to be any reason for Ann to take any action regarding her Market Linked Pension.

However, Ann holds other funds, about \$200,000, in her SMSF in Accumulation Phase, which she would like to move into an Account Based Pension.

If Ann was to now:

- commute her Market Linked Pension; and
- commence a new Market Linked Pension,

the amount recorded in her Transfer Balance Account would be \$1,400,000, the actual balance of the Market Linked Pension (assuming that balance had remained approximately the same since 30 June 2017), leaving room for her to commence an Account Based Pension with the other \$200,000, taking her Transfer Balance Account to \$1,600,000.

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## Transfer Balance Account

Unfortunately, there is a Transfer Balance Account issue which needs to be overcome.

What appears to have been an unintended consequence of the drafting of the Superannuation Reform legislation is, according to the ATO, the fact that the commutation of the Complying Pension on or after 1 July 2017 will provide a zero debit to the Transfer Balance Account.

That will effectively result in double counting.

The pension will have provided a credit at 1 July 2017 and a further credit will be recorded for the commencement of the new Market Linked Pension – albeit using the same funds, with no corresponding debit.

In recognising this, the ATO and Treasury are looking to rectify the anomaly. In the meantime, the ATO has released CRT Alert 066/2018, in which they advised they would not take compliance action in regards to either non-reporting or incorrect reporting of the Transfer Balance Account events.

## What is needed to be done?

The trust deed must provide power for the Trustee to commute the Life Expectancy, Lifetime or

Market Linked Pension, and authorise the commencement of a new Market Linked Pension.

Additionally, various documents, such as member requests, Trustee resolutions and agreements are required, which Topdocs can assist with.

## Conclusion

If waiting for the term to expire, or the death of the pensioner, it will be too late to take action.

With Complying Pension recipients reaching quite senior ages, action should be taken sooner rather than later.

Similarly, with existing Market Linked Pensions, action may provide a better outcome for clients with pension balances under \$1,600,000.

Consider it a Call to Action!

## Notes

1. An unallocated contributions 'reserve' is also permitted, but the ATO considers that to be an 'account' rather than a reserve.
2. For simplicity, we are referring only to the pensioner, but, in reality, that term would include a reversionary pensioner.
3. Depending on Jenny's personal assessable income, some excess concessional contributions tax may have limited impact.
4. Before commuting a complying pension, consideration should be given to the loss of any Asset Test

Exemption entitlements under Centrelink and/or Department of Veterans Affairs rules.

## More information

Should you have any queries, or require more information, please contact the team at Topdocs on 1300 659 242.

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