SUPERANNUATION INCOME STREAMS – WHEN CAN OR MUST A VALID AUTOMATIC REVERSION BE PUT IN PLACE?

This technical paper considers the timing of automatic pension reversions, following the release of TR 2013/5, the finalised version of TR 2011/D3 which engendered debate and differing points of view amongst advisers.

Following the release by the Australian Taxation Office (ATO) of its draft Taxation Ruling TR 2011/D3 'Income tax: when a superannuation income stream commences and ceases', in July 2011, a greater focus has been placed on the automatic reversion of pensions, at the time of death of a pension recipient. The long awaited release of a finalised version of TR 2011/D3 was deferred a number of times but, finally, on 31 July 2013, the ATO released TR 2013/5, also titled 'Income tax: when a superannuation income stream commences and ceases'.

Reaction to the position taken by the ATO in TR 2011/D3 was largely in connection with the ATO's contention that a pension ceased, following the death of the recipient, unless clear instructions were in place to continue the pension to a nominated recipient.

Although the ATO's position has not changed in TR 2013/5, the response to the finalisation of the Taxation Ruling has been much more subdued, for a significant reason.

In its '2012-13 Mid-Year Economic and Fiscal Outlook' ('mini-budget') of October 2012, following the release of TR 2011/D3, the Government announced it would legislate to change the impact of some of the findings in the draft ruling to, in particular, allow the tax exemption in regards to income and capital gains generated from assets supporting pensions to continue past the death of the pensioner.

The Government subsequently made amendments to the Income Tax Assessment Regulations through the introduction of 'Income Tax Assessment Amendment (Superannuation Measures No. 1) Regulation 2013', meaning the announced changes have now become law.

The effect of the amending regulations is that they have introduced provisions that apply, following the death of a member, in relation to assets supporting a pension previously payable to the member. Basically:

- if no automatic reversion of the pension occurs; and
- the benefit is paid as either a lump sum or a new income stream; and
- the benefit is paid as soon as practicable after the death of the member;

the income and capital gains derived from those assets, following the death of the member, will not be taxed.

The release of TR 2011/D3 engendered some debate and differing views amongst practitioners in regards to the timing of the completion of nominations for the automatic pension reversion to validly occur in a superannuation fund.

In particular, a range of views exist over whether automatic pension reversion nominations may be added, or removed, at any time during the course of the pension, and whether they can be in the form of either an automatic pension reversion nomination or a Binding Death Benefit Nomination (BDBN).

A widely held view is that automatic pension reversion nominations may be added or changed during the course of the income stream, so long as:

- the trustee is permitted under the trust deed of the SMSF to accept either document;
- the trustee acknowledges receipt of an automatic pension reversion nomination; and
- with a BDBN, the BDBN clearly states the benefit is to be paid in the form of a pension.

There does not appear to be any disagreement with the suggestion that BDBN's may be created during the course of an income stream.

Discussion of the ATO views and the issues involved as to the timing of nominations is considered further in this paper.

Detail

A recipient of a superannuation income stream may be able to direct the trustee of their super fund to continue paying the pension to a nominated dependant on their death, provided:

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- the trust deed of the fund permits the trustee to accept such instructions;
- the nomination is correctly completed and accepted by the trustee; and
- the nominated recipient(s) are permitted under the legislation to receive their entitlement to death benefits in the form of an income stream.

The document used by a fund member to nominate a dependant to succeed them in receiving the pension is generally known as an 'automatic pension reversion nomination'.

In its Taxation Ruling, TR 2013/5, the ATO refers to the process, following the death of a pension recipient, as the 'automatic transfer' of the pension.

Is an automatic pension reversion still necessary?

The amendment of the ITA Regs referred to previously has removed some of the 'necessity' to have the automatic pension reversion which TR 2011/D3 seemed to highlight.

In reality, that takes us back to the position before the release of the draft ruling.

In other words, it may not be necessary - to minimise tax payable - but it can assist to reduce unnecessary actions the ones left behind need to undertake.

An automatic pension reversion nomination enables the pension to be paid to a spouse, for example, with potentially very little activity required on the part of the new recipient.

What are the timing issues?

The question as to the proper timing in which an automatic reversionary nomination should be completed by the initial pension recipient, and accepted by the trustee, has elicited differing opinions from experienced superannuation practitioners, which has prompted us to do some deeper research.

The conservative position, and the most simplistic view, is that:

- the automatic reversion nomination should be provided to the trustee at the time of commencement of the pension; and
- if the intent to change the reversionary beneficiary arises, the pension should be stopped and re-commenced (reset), with a new automatic pension reversionary nomination in place at the (re)start.

Firstly, a bit of history

Automatic reversions were originally introduced as an option on annuity contracts, where the annuity was paid for the lifetime of both the initial recipient and any subsequent recipients. Therefore, the decision about whether to make an annuity reversionary or not had to be made at the outset, because the amount of annual income paid to the recipient was calculated on the life expectancy of the income recipient. If there were to be more than one recipient, then the life expectancy of the longest life was used in the actuarial calculations.

Because of the nature of the calculations, the recipient could not add a reversionary beneficiary at a later date. Any change required a stopping of the annuity and commencement of a new contract.

Although not annuity 'contracts' as such, defined benefit superannuation pensions, both public and private sector, were calculated in a similar way and had similar restrictions.

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At the time, there was also a tax related issue which complicated any attempt to add an automatic reversionary beneficiary after the pension had commenced. The forebear of the taxable and tax free components which we now use to calculate the taxable amount within the payment of most pensions, was the 'undeducted purchase price'.

From the undeducted purchase price, an annual 'deductible amount' was calculated, at the commencement of the pension, based on the life expectancy of the younger of the initial recipient and the reversionary pensioner.

Both the total pension payments and the deductible amount were included in the recipient's income tax return each year, with the deductible amount effectively reducing the tax impact on the amount received. There was no mechanism in the Income Tax Assessment Act 1936 which allowed a fund to re-calculate the deductible amount once a pension had commenced.

For most pensions, those issues went away on 1 July 2007, when the crystallisation of a range of member benefit components, into taxable and tax free, occurred in most fund member accounts, and only the taxable part of those pensions was subsequently included in the recipient's income tax return. However, maybe the 'old habits' have lingered.

What about legislative provisions?

Although automatic pension reversions generally use the principles of s 59(1)(a) of the SIS Act, the ATO is of the view that the provisions of s 59(1)(a) do not apply to SMSFs (ATO SMSF Determination SMSFD 2008/3 - 'Self Managed Superannuation Funds: is there any restriction in the Superannuation Industry (Supervision) legislation on a self managed superannuation fund trustee accepting from a member a binding nomination of the recipients of any benefits payable in the event of the member's death?'). So, in a SMSF, it would seem that members can make nominations in whatever kind of format they wish, as long as:

- it does not contravene a tax law;
- the person to be paid is a SIS dependant (but excluding non-disabled children over age 18 not financially dependent or over age 25); and
- the trust deed of the fund permits the chosen format.

Specifically, there does not appear to be any legislative provision which prevents an automatic pension reversion nomination from being made after the commencement of a pension.

And the SMSF Trust Deed?

The governing rules of the fund should be constructed so as to either specifically allow, or at least not prohibit, the addition of an automatic pension reversion nomination after the commencement of the pension. For example, the Topdocs SMSF Trust Deed contains:

- no requirement that the automatic reversion be in place at any particular time prior to death; and
- specific references to the test of the qualification to be a reversionary beneficiary being **at the time of death** of the pensioner.

Whilst many public offer funds will not have changed their governing rules since 2007 (or not changed their administrative processes) to allow a reversionary beneficiary to be added after commencement, the flexibility of SMSFs means that a properly drafted and up to date trust deed should not prohibit the addition of a reversionary beneficiary at any time during the course of the pension.

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Are there any reasons for concern?

There is possibly some concern if the pension recipient is also in receipt of Centrelink benefits. To calculate the exempt amount of pension income for social security purposes, life expectancy factors are still used.

The Centrelink website includes, as part of its 'Guide to Social Security Law', a section dealing with the action of adding or removing a reversionary beneficiary, stating "It may be necessary for Centrelink to recalculate the deduction amount and assessable income. However, the purchase price and commencement date remain unchanged."

What format should the nomination take?

The governing rules of the SMSF may or may not provide the format for a document to effectively direct the automatic reversion of a pension. The standard type of reversionary beneficiary nomination is a form of letter to the trustee, and a resolution of acceptance of the notice by the trustee. Those documents form part of the 'rules' of the income stream.

Another means by which a reversionary beneficiary nomination can be established is as part of a binding death benefit nomination (BDBN). Interestingly, reference in TR 2011/D3 to BDBNs was removed for the final version. However, that does not appear to be for any reason other than to cover all of the various documents which can provide for automatic pension reversions, including the Trust Deed.

In TR 2013/5, the ATO states (inter alia):

126. A superannuation income stream automatically transfers to a dependant beneficiary on the death of a member if the governing rules of the superannuation fund, or other rules governing the superannuation income stream, specify that this will occur. The rules must specify both the person to whom the benefit will become payable and that it will be paid in the form of a superannuation income stream.

SMSF Trust Deeds

It is absolutely crucial that the trust deed is checked to determine whether it allows the death benefits to be paid in the manner intended by the member, and permits the trustee to accept the automatic reversion nomination and/or the BDBN. If the trust deed does not contain those powers, it should be updated.

What is 'best practice'?

In light of the uncertainty from the varying opinions of respected practitioners, it could be said that best practice would be achieved by way of the 'conservative' approach referred to earlier in this paper. However, that may not always be the most practical option.

Consider the situation of a pension recipient, who:

- is receiving a pension from an account comprising mainly tax free money;
- has an accumulation account comprising mainly taxable component; and
- wishes to nominate a reversionary pensioner to the existing pension.

To reset the pension and add a reversionary beneficiary, when commencing the new pension, will result in the mingling of the taxable and tax free components, undoing earlier estate planning which may have anticipated those components being kept separate.

So long as there is no prohibition under the SMSF trust deed, the recipient could complete either a BDBN which clearly directs a pension to a nominated recipient,or an automatic pension reversion nomination in this circumstance.

However, completing an automatic pension reversion subsequent to the commencement of the pension may not provide the same degree of certainty that restarting the pension, with an automatic pension reversion nomination in place at commencement, would provide.

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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