Complying defined benefit pensions and estate planning

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Many complying defined benefit pensions are Asset Test Exempt (ATE) for Centrelink purposes, which makes them a very valuable and attractive investment vehicle for the pension recipient. Although holders of these pensions can reap the rewards of the preferential Age Pension treatment whilst the pensioner is alive, a complying defined benefit pension could be highly inflexible and restrictive when discharging the benefits when pensioners pass away.

In this article we look at some of the complications for estate planning with these types of pensions as well as some potential solutions.

For the purposes of estate planning complying defined benefit pensions can be categorised as follows:

- Reversionary lifetime pensions
- Non-reversionary lifetime pensions
- Life-expectancy pensions (fixed term pensions)

Reversionary lifetime pensions

Complying lifetime pension were able to be established with terms that provided for a reversionary beneficiary. Provided that the reversionary beneficiary satisfies the requirements to be a dependent (under superannuation and taxation law), then on the primary beneficiary's death, the lifetime pension will continue to be paid to the reversionary beneficiary as per the original terms of the pension.

In these circumstances the lifetime pension is likely to retain its ATE status in the hands on the reversionary beneficiary.

On the primary beneficiary's date of death the special value of the lifetime pension would be recalculated and this special value will count towards the reversionary beneficiary's transfer balance account 12 months from the date of death.

If the reversionary beneficiary of the lifetime pension does not meet the requirements to be a dependent under superannuation law (i.e. non-dependent adult child) then the lifetime pension cannot be paid as an income stream to that reversionary beneficiary. Trustees should seek legal advice to determine whether they have a liability to pay a benefit to that reversionary beneficiary and whether the benefit can be paid as a lump sum.

For information on complying lifetime pensions already being paid to a reversionary beneficiary please refer to non-reversionary lifetime pensions section. It is our understanding that complying pensions can only revert once to a new beneficiary.

Lump sum payment to the reversionary beneficiary

According to the SIS Regulations, on primary beneficiary's death, the lifetime pension can be commuted to the benefit of the reversionary beneficiary if the primary beneficiary's death occurred within the shorter period of the following periods:

- Primary beneficiary's life expectancy on the commencement day, rounded up to the next whole number, or
- 20 years.

Please refer to the fund's trust deed for confirmation that reversionary benefits can be paid as a lump sum.

Non-reversionary lifetime pensions

The SIS Regs (1.06(2)) governing lifetime pensions do not provide to the payment of a superannuation death benefit on the death of the last beneficiary. As such, our understanding is that if the complying lifetime pension was established as a non-reversionary pension then on the primary beneficiary's death any remaining assets supporting the lifetime pension would remain in an unallocated reserve in the self-managed superannuation fund (SMSF). It may still be possible to pay out these assets as death benefits, but they would first need to be allocated to the deceased member in line with the rules governing allocations from reserves.

Note that in the following instances a reversionary lifetime pension would only have one beneficiary and be treated as a non-reversionary pension:

- The complying lifetime pension is currently being paid to a reversionary beneficiary on death of the primary beneficiary, or
- The primary beneficiary has outlived the reversionary beneficiary.

The unallocated reserve would be in the control of the trustees of the SMSF. The trustees could allocate the money from the reserve to member interests in the fund (including the deceased) but it is important to take note of the taxation treatment of those distributions, as specified in ITAR 291-25.01. According to that regulation:

1. Each fund member can receive allocations up to their concessional contribution cap each year. Age and work-test restrictions do not apply because the reserve is already in the superannuation system. The concessional limit applies because monies in the super system are concessionally taxed. It is our understanding that the lump-sum allocation must be grossed-up to determine the equivalent concessional contribution. For example, a lump-sum allocation of $8,500 to a member must be counted as a concessional contribution of $10,000. Excess contributions tax may be levied if the total of all concessional contributions to that member in a year exceeds their contribution limit.

OR

2. Distributions to member accounts less than 5% (say 4.99%) are permitted without being counted against contributions limits. For example if a member has an account-based pension in the fund with a balance of $100,000 then less than $5,000 can be transferred to an account for that member without counting towards the concessional contribution cap, for that year. A particular requirement of this distribution method is that all member interests in the fund must be increased in a fair and equitable manner. For example, a distribution from the reserve of 4.99% of the value of all member interests must occur at the same time.

Our understanding is that only one method can be utilised to allocate money from the reserve in a financial year.

Life-expectancy pensions

A complying life-expectancy pension is a type of term pension that can continue to be paid until the end of the specified term.

If the original term of the life-expectancy pension was determined based on the reversionary beneficiary's life expectancy then, on the primary beneficiary's death, the pension will continue to be paid to the surviving reversionary beneficiary until the end of the term of the original pension. In all other instances it is possible to pay a lump sum benefit when the original pensioner passes away.

When commuting a life-expectancy pension, regulation 1.08 of the SIS Regulations restricts the amount that can be commuted to a lump sum. According to that regulation, the maximum amount that can be commuted to a lump sum is determined by reference to Schedule 1B in the SIS Regulations.

If the value of the assets supporting the life-expectancy pension exceeds the maximum commutation value calculated according to the regulations then the trustees can only commute the maximum commutation value into a lump sum and the surplus assets would remain in an unallocated reserve in the SMSF. If the value of the assets supporting the life-expectancy pension is lower than the maximum commutation value then all the assets supporting the life-expectancy pension can be commuted to a lump sum.

For life-expectancy pensions commenced prior to 20 Sep 2004, if the reversionary beneficiary continues to receive the life-expectancy pension as an income stream then the reversionary beneficiary may retain the ATE status of the life-expectancy pension if the following conditions are satisfied:

- The remaining term of the income stream (rounded up to the next whole number of years) is equal to the reversionary beneficiary's life expectancy rounded up to the next whole number of years, and
- The reversionary beneficiary has reached Age Pension age.

For life-expectancy pensions commenced between 20 September 2004 and 19 September 2007, if the reversionary beneficiary continues to receive the life-expectancy pension as an income stream then the reversionary beneficiary may retain the ATE status if the reversionary beneficiary meet the definition of a 'reversionary partner'. Section 9B(6) of the SIS Act defines a 'reversionary partner' as:

Reversionary partner, in relation to the primary beneficiary of an income stream and a particular day, means another person who, on that day:

- is a member of a couple with the primary beneficiary; and
- is the person to whom the income stream will revert on the primary beneficiary's death.

If the conditions above are not met then the ATE may be lost despite the pension continuing to be paid to the reversionary beneficiary. Assets supporting the pension would then be included in the Centrelink means tests, potentially reducing the surviving spouses Age Pension.

When the life-expectancy pension reverts to a beneficiary, the special value of the life-expectancy pension would be recalculated on primary beneficiary's date of death and this special value will count towards the reversionary beneficiary's transfer balance account 12 months from the date of death.

Changing or adding a reversionary beneficiary

Where a reversionary beneficiary of a complying pension (lifetime or life-expectancy) has to be changed (e.g. due to divorce, death or in some instances where the reversionary beneficiary in a non-dependent adult child) the existing complying pension would have to be ceased and a new complying income stream would have to be commenced with the new reversionary beneficiary.

As it has not been possible to commence a new complying pension since 1 January 2006, the new complying income stream would have to be a market linked pension or a retail complying annuity.

It is possible for the new complying income stream to retain the ATE status of the original complying pension. For pensions with a 100% ATE the only option for retaining this is to commence a complying annuity. For those lifetime pensions that have a 50% ATE this may be retained with either a market-linked pension or an annuity.

In order to retain the ATE status certain conditions must be met. You can find these additional relief conditions here: http://guides.dss.gov.au/guide-social-security-law/4/9/2/17

Planning ahead

As outlined above, there are a number of difficulties that can arise when a member passes away when still in receipt of a complying defined benefit pension. However, assets being trapped in reserves or the loss of valuable Age Pension entitlements can potentially be avoided by planning ahead.

Restructuring a defined benefit pension now may put the member's beneficiaries in a better position when they pass away. It is often possible to commute these types of pensions if the proceeds are used to commence new complying income streams.

Both of the two types of income stream that are now available for this purpose, market-linked pensions and complying annuities, offer superannuation death benefits avoiding the issue of trapped reserves. Market-linked pensions offer some flexibility and allow the assets to be retained in the SMSF. Commuting to start a complying annuity may have the added attraction of retaining the 100% ATE for Age Pension purposes.

For further details on options for commuting defined benefit pensions see our webpage on this topic which includes a wealth of information and support.

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