ACCURIUM

Understanding defined benefit pensions in an SMSF Q&A

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Q.1 If a lifetime defined benefit pension (DBP) member passes away and they are the last member in the fund, what are the implications when allocating out of reserve and to the estate. Does excess concessional contributions tax get paid on amounts in excess of the concessional cap for that member even though it's their estate receiving it?

A.1 If the lifetime DBP member passes away and he/she is the last member of the fund then the residual assets backing defined benefit pension will remain in the reserve. The balance in the reserve cannot be paid to the member's estate. Technically, new member(s) would have to join the fund and the trustees could allocate the balance in the reserve to the newly joined member(s). When making allocations to new member(s) the trustees will have to adhere to ITAR 292-25.01.

The alternative is to apply for an ATO private ruling, requesting the remaining balance of the reserve paid to the member's estate.

Q.2. If a pension has an unsatisfactory or inadequate opinion and you are converting a DBP to a TAP, do precise pro-rata pension payments need to be made for the DBP for the days since last anniversary to the conversion date?

A.2 This depends on the terms of the DBP. It is important to understand that DBP payments are not bound by the minimum pension standards. Instead, the timing of DBP payments is governed by the anniversary of the start date, which very often does not coincide with the financial year. Annual DBP payments must be completed during each 12 month period starting at the anniversary. If the DBP payments are made 'annually in advance' then the pension payment must be paid at the start of each 12 month period. If the DBP payments are made 'annually in arrears' then the pension must be paid as a lump sum at the end of each 12 month period. If the pension payments are made 'monthly' or 'quarterly' then payments must be pro-rated for the number of elapsed payment intervals between the anniversary and the conversion date.

Q.3. Is the allocation from the reserve to members taxable? Or just treated as a concessional contribution?

A.3. An allocation from the DBP reserve to members is not taxable. The funds in the reserve are already in the superannuation system therefore it is not taxable. It may, however, count towards the member's concessional contribution cap if the funds are not allocated to all member interests in the SMSF in a fair and equitable manner. It is our understanding that any allocation from the reserve that counts towards a member's concessional contribution caps should be grossed up for the contribution tax. For example, if the trustees allocate $8,500 from the reserve to Member A, then that allocation should be treated as a $10,000 concessional contribution for Member A.

Q.4. If the last member of the SMSF dies, what happen to the balance in the account?

A.4. See questions 1 and 7.

Q.5. With the Centrelink income test changes from 01/01/16, presumably more of the DBP will count under the income test. Do these new rules apply to all DBP regardless of the commencement date?

A.5. The new Income Test rules do not apply to DBPs paid from an SMSF. The new Income Test rules apply to fully funded employer superannuation schemes or government employee superannuation schemes (excluding military defined benefit pensions).

Q.6. How does the investment strategy affect the results?

A.6. We use the investment strategy to set an appropriate investment return assumption, or discount rate, to calculate the present value of all the possible future pension payments (also known as the best estimate valuation). Generally, a higher allocation to growth assets allows us to assume higher investment returns over the long term. Higher assumed returns mean a lower value will be placed on the liabilities.

Q.7. When a member dies, the balance remaining in the fund can be paid to the estate. Is this taxable in the estate?

A.7. When a member receiving a lifetime DBP passes away, the remaining balance of the defined benefit reserve cannot be paid to the estate (see question 1).

When a member receiving a life-expectancy (fixed term) DBP passes away, the remaining pension payments until the end of the or a lump sum equivalent of the remaining pension payments can be paid to the estate. If the trustees decide to pay the lump sum equivalent, then the lump sum is capped by the maximum permitted transfer value, calculated based on SISR Schedule 1B.

Lump sums paid as above would be taxed in the same way as any other superannuation death benefit, lump sum payment made to a member's estate. That is, it depends on who the ultimate beneficiaries are and the taxable/tax-free components of the pension.

Q.8. If a DBP can be commuted to commence a TAP, can TAP term be different to what's in the DBP, for example, add/remove auto reversionary or reduce/increase the term of the pension?

A.8. When commuting a DBP and commencing a TAP, the member is effectively starting a new complying pension. The new complying pension can have different terms to the original complying pension.

Q.9. How to make allocation from reserves if a member is over 75-years-old?

A.9. To receive allocations from the reserve the member doesn't need to satisfy the Work Test or the Age Test because the funds are already in the superannuation system.

Q.10. If we stop the DBP prior its expiry date, what amount goes to the reserves?

A.10. All monies in the DBP account remain in reserve. The DBP account is a special sub-fund that is controlled by the trustees. The pensioner has a vested interest in that sub-fund to the extent that they are owed a pension stream, but it does not belong to them in the same way as an account-based pension. If the DBP stops, for whatever reason, the residual capital remains in that sub-fund under the control of the trustees. In limited cases some or all the sub-fund is payable as a lump-sum to the pensioner or their estate, but this depends on the type of DBP and the reason it was stopped.

Q.11. How can you allocate more income to a DBP?

A.11. Trustees are expected to distribute investment returns in a fair and reasonable manner. In practice this means distributing in proportion to the account balances. However, if the Trust Deed gives the trustees discretion to vary allocations in any way they wish, then it may be possible to justify a non-proportional distribution that favours the DBP account.

Q.12. If we can't add to a DBP, does it mean at some point in time the pension would be inadequate and fall out of the asset exemptions?

A.12. Funding shortfalls sometimes occur but they are not inevitable. The purchase prices of DBPs (the amount initially set aside to fund them) in SMSFs is calculated to allow for contingencies such as, pensioner longevity and fluctuations in investment returns. Provided longevity and market performance do not severely deviate from predicted levels then inadequacy is unlikely.

Q.13. Are all DBP payments always tax free pensions, in the pensioners hands?

A.13. If this question relates to personal income tax then yes, DBP payments from an SMSF is tax-free provided the pensioner is at least 60-years-old. In other cases it may depend on the taxable and tax-free components of the DBP account and the circumstances in which the DBP became payable.

Q.14. When do trustees have to transfer an unallocated reserve to other members after a member dies?

A.14. There is no time limit. An unallocated reserve can remain in place indefinitely.

Q.15. What happens if the member takes too much?

A.15. Trustees must take care to avoid this situation because there is no straightforward solution. The timing of the excess payments can be considered. DBP payment deadlines coincide with the anniversary of the start date which often is not the financial year.

Not paying the pension in line with the terms is a contravention and should be reported to the ATO. However, taking appropriate action to rectify the error by repaying the overpaid pension or reducing the payment the following year, is likely to be looked on favourably by the ATO in these situations. Where a pension is Asset Test exempt it is also important to discuss the error with Centrelink and explain the efforts to make good the mistake.

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