Why defined benefit pensions are not 100% tax exempt

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Unlike most pensions in a self-managed superannuation fund (SMSF), the income earned on assets supporting a defined benefit pension is not necessarily 100% exempt from income tax.

Section 295-390 of ITAA 1997 sets out how much of a superannuation fund's income is exempt from income tax. The proportion of income that is exempt from tax is determined by an actuary in line with the ratio of a fund's superannuation liabilities that are classed as current pension liabilities.

For account-based pensions (including transition to retirement and market linked pensions), current pension liabilities are simply equal to the pension account balance. Therefore for a fund whose assets are wholly supporting such pensions, the fund's income will be 100% tax exempt.

However, for a defined benefit pension the current liabilities are determined by the actuary based on the 'best estimate' of the expected present value of future pension payments. The value of the current pension liabilities may be more or less than the value of the assets supporting the pension.

In line with the Institute of Actuaries' professional guidance note, Accurium's view is that, at any point in time, an SMSF's superannuation liabilities are no less than the fund's total net assets. Where the value of an SMSF's assets exceeds the value of the current pension liabilities, not all of the fund's income will be exempt from tax. This is the case even for a fund where assets are wholly supporting defined benefit pensions. This is supported by ATO ID 2002/368 which states that the value of the assets held by a complying superannuation fund that can be classified as current pension assets for the purposes of claiming a tax exemption may not exceed the value placed on the current pension liabilities by an actuary, as determined on a 'best estimate' basis. Note that this ID has recently been withdrawn due to references it made to old legislation. However, as the legislation that replaced it is broadly unchanged, we believe that this is still likely to represent the ATO's view on this issue.

If we consider an SMSF with one member, with all assets supporting a defined benefit pension. Based on the future pension payments the fund is required to make, the actuary determines that his best estimate of the current pension liabilities is $200,000. However, the fund's assets are valued at $250,000.

The proportion of the fund's income that is exempt from income tax is determined as the value of the current pension liabilities ($200,000) divided by the value of the total superannuation liabilities (which is equal to the total value of the assets, i.e. $250,000). The percentage of the fund's income that is exempt from tax is therefore 80%. Note, in practice the calculations would not be this simple as the legislation requires the use of average liabilities over the tax year rather than at one point in time.

Suppose instead that the value of the fund's assets had only been $150,000. In this case 100% of the fund's income would be exempt from tax. There would, however, be solvency issues that the fund would need to address, we will not discuss those issues here. Please contact us if you would like further information.

Practitioners who have clients with defined benefit pensions will be aware that these funds require an annual adequacy statement from an actuary. This provides the actuary's opinion on whether there are sufficient assets supporting the pension to meet the benefit obligations. Accurium's defined benefit pension reports include both an adequacy opinion and the tax exempt percentage required to calculate the fund's exempt current pension income.

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