

AUTOMATIC REVERSIONARY PENSIONS

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AUTOMATICALLY REVERSIONARY PENSIONS AND SUPER REFORM

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INTRODUCTION

The \$1.6 million balance cap proposal adds another layer of complexity to understanding whether an automatically reversionary pension ('ARP') is still an appropriate SMSF succession planning strategy.

WHAT IS AN ARP?

We refer to the term ARP and deliberately avoid the term 'reversionary pension' as a reversionary pension is generally a mere wish in relation to paying the pension to a nominated beneficiary. Under most SMSF deeds and pension documents, trustees retain a discretion to make a pension reversionary even though a member has nominated a reversionary beneficiary. Broadly, this has worked well over many years where a member separates with his or her spouse, as the last thing many deceased members would like happening is for their superannuation benefit to be paid to their former spouse.

In contrast, an ARP is a pension that must be paid to the nominated beneficiary without any exercise of discretion by the fund trustee. Special wording in an SMSF deed and pension documentation is required to ensure a pension is an ARP as discussed below. This is to abide by the ATO's view in TR 2013/5 where the Commissioner states at [29]):

Death of a member

29. A superannuation income stream ceases as soon as a member in receipt of the superannuation income stream dies, unless a dependant beneficiary of the deceased member is automatically entitled, under the governing rules of the superannuation fund or the rules of the superannuation income stream, to receive an income stream on the death of the member. If a dependant beneficiary of the

deceased member is automatically entitled to receive the income stream upon the member's death, the superannuation income stream continues.²²

Moreover, the ATO elaborates on what constitutes 'automatic' for tax law purposes in TR 2013/5 at [126]:

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. The rules may also specify a class of person (for example, spouse) to whom the benefit will become payable. It is not sufficient that a superannuation income stream becomes payable to a beneficiary of a deceased member only because of a discretion (or power) granted to the trustee by the governing rules of the superannuation fund. The discretion (or power) may relate to determining either who will receive the deceased member's benefits, or the form in which the benefits will be payable.

Accordingly, if there is any discretion afforded to the fund trustee under the governing rules of the fund or the pension documentation in regard to paying a particular superannuation dependant or the payment method, the ATO will consider the pension ceases on death for tax law purposes. This can have important consequences for SMSF succession planning, including insurance payouts and the retention of other valuable concessions.

We turn now to consider some key areas where having an ARP in place can provide some advantages.

INSURANCE

For those SMSF members who do hold a life insurance policy in their SMSF, an ARP may be worthwhile if the following conditions are satisfied:

- the SMSF member is likely to receive a sizeable insurance payout upon their death or permanent incapacity;
- the relevant insurance policy premium is paid from the member's pension account; and
- the relevant pension account that serviced the insurance premiums is comprised of a high proportion of tax-free component.

Broadly, in these circumstances, when a life insurance payment is allocated to a member's pension account, the payment will broadly take on the same proportion of the underlying taxable and tax-free components as the member's pension.

Example:

If a deceased member commenced a pension entirely comprising tax-free component, and the insurance premiums were deducted from that member's pension account, then the \$1 million insurance proceeds paid to the SMSF on that member's death and allocated to the deceased member's pension account would constitute a 100% tax-free component. This could fund a tax free reversionary pension.

In contrast, if a deceased member's pension ceased on death, any insurance proceeds that are subsequently paid into the fund would form part of member's accumulation account and comprise a 100% taxable component.

GRANDFATHERING OF FAVOURABLE INCOME TESTING

Another area where ARPs may prove important is for the retention of concessions that relate to income testing.

For instance, the eligibility testing for the age pension provided by Centrelink or the Department of Veteran Affairs ('DVA') includes a more favourable income test for account-based pensions ('ABP') in place prior to 1 January 2015.

For ABPs that commenced prior to 1 January 2015, only the amount of pension withdrawn less a deductible amount (broadly, the deductible amount is the amount of the member's pension account divided by their life expectancy) counts towards the income test. However, for ABPs commenced from 1 January 2015, the amount of the member's pension account for an ABP is deemed to earn income at prescribed rates for the purposes of the income test (even though the member's account balance has suffered a loss).

Where an ARP was in place prior to 1 January 2015, and thus the pension continues on the member's death, the more favourable income testing regime for ABPs commenced is grandfathered for the reversionary pensioner.

Eligibility for the Commonwealth Seniors Health Card ('CSHC'), which allows access to cheaper prescriptions via the pharmaceutical benefits scheme and provides certain other government funded medical services, may also be affected.

Prior to 1 January 2015, ABPs were not assessed for CSHC eligibility. However, since 1 January 2015, earnings on the assets supporting ABPs are assessed under the adjusted taxable income test. The income from the ABP will also be taken to have a deemed rate of return.

Having an ARP in place enables a reversionary pensioner to preserve the potentially favourable 'grandfathered' status for Centrelink, DVA and CSHC income testing in respect of ABPs that commenced prior to 1 January 2015. This allows, for instance, a surviving spouse to continue to

be paid a pension following the death of their spouse, and therefore, continue the favourable income treatment of a pre-2015 ABP.

\$1.6M BALANCE CAP

The \$1.6 million balance cap proposal included in the May 2016 Federal Budget will limit the amount that a member can hold in retirement or pension phase from 1 July 2017. This will limit or cap the amount that obtains the exempt current pension income ('ECPI') exemption from tax in a fund. Broadly, from 1 July 2017 only earnings on assets capped at \$1.6 million that support the fund's liability to pay a pension will be tax-free. The balance cap proposal also allows earnings on the \$1.6 million to obtain the ECPI exemption as there are no restrictions proposed to be placed on subsequent earnings on the \$1.6 million balance cap amount, which will be allowed to be maintained in the fund.

While the draft legislation for the balance cap proposal has yet to be released (there may also be a chance that the start date of 1 July 2017 gets deferred for the systems to be implemented to cater for the wide spread changes relating to this measure), it does appear that this proposal will significantly impact SMSF succession planning.

This is because a death benefit pension (ie, an ARP on the death of a spouse) paid to a surviving spouse who has already utilised their \$1.6 balance cap will likely result in additional tax payable. Additional tax is likely to arise through a requirement that the death benefit be paid as a lump sum on the spouse's death as the surviving spouse already has used up their balance cap.

Alternatively, assuming the pension can revert under the proposal, then since the surviving spouse has already used up their balance cap, any further amount added to their member balance in superannuation could be subject to substantial tax. The \$1.6 million balance cap has an excess balance transfer tax that applies when someone seeks to transfer an amount in excess of their balance cap to their retirement account. This tax is equivalent to 49% of the excess amount. If an ARP locks in a reversion, subject to what the finalised law provides, and an excess pension phase transfer occurs above the balance cap then the excess will be subject to penalty tax of 49%. Naturally, this would have a severe impact on SMSF succession planning for many couples.

If, however, there is no flexibility provided under the proposed legislation in reverting to a spouse who has already used up their balance cap, then this may result in a compulsory cashing event for the deceased spouse requiring a lump sum payment to be made. Since the ECPI will only cover tax on assets up to a maximum of \$1.6 million (plus earnings thereon as indexed), then the other assets that need to be liquidated or disposed of may give rise to taxable gains on which tax is payable. Over time, considerable extra revenue is likely to be raised through this measure by the ATO.

Accordingly, members in retirement phase with pension account balances exceeding \$1.6 million can no longer rely on ECPI applying to any death benefit pensions paid to them as a surviving spouse or eligible beneficiary. There is likely to be detailed discussion and, hopefully some meaningful consultation, in relation to these concerns before the legislation is finalised.

Accordingly, the \$1.6 million balance cap represents a new hidden death tax and it poses a challenge for ARPs as a tax effective SMSF succession planning tool.

However, many people will still probably want to position themselves with an ARP until the uncertainty of how the \$1.6 balance cap measure is resolved. If the ARP results in the surviving spouse's balance cap being exceeded further planning at or before that time may be needed.

REDUCED FLEXIBILITY IN RELATION TO IN SPECIE TRANSFERS

There can also be disadvantages in having an ARP. Having an ARP in place may, for instance, reduce the flexibility in relation to an in specie payment of superannuation death benefits.

The extension of the pension exemption on death for non-ARPs under sub-regs 995-1.01(3) and (4) of the *Income Tax Assessment Regulations 1997* (Cth) provides greater flexibility in relation to payment of assets supporting a pension to a fund member. Broadly, these provisions enable a lump sum death benefit to be paid by way of an in specie transfer of assets and be treated as an income stream payment covered by ECPI subject to the balance cap limit from 1 July 2017.

Note that these regulations do not apply to an ARP. To pay a lump sum by way of an in specie transfer of an asset in the context of an ARP, the ARP must be partially commuted, which can create complications for claiming ECPI (subject also to the balance cap proposal).

SMSF AND PENSION DOCUMENTATION

The above strategies depend on quality smsf, pension and other documentation. Many smsf deeds and pension documents may not provide an adequate foundation to implement an arp consistent with the ato's view in tr 2013/5.

Accordingly, advisers should ensure that their clients have appropriate documentation in place to implement their clients' smsf succession plans, including a strategic smsf deed supported also by appropriate pension and bdbn documentation.

Naturally, dba lawyers' smsf deed and related documents provide for and support smooth and tax-effective smsf succession planning outcomes.

CONCLUSION

As can be seen from the above, ARPs are not a 'one-size-fits-all' solution for every situation, but they do have a strategic role to play in tax-effective SMSF succession planning.

Advisers should be aware of the benefits and challenges of utilising ARPs, including in the context of insurance, government concessions, and the proposed \$1.6 million balance cap.

For more information on ARPs, refer to:

<http://www.dbalawyers.com.au/pensions/what-wins-out-an-automatically-reversionary-pension-arp-or-a-binding-death-benefit-nomination-bdbn/>

For more information on the \$1.6 million balance cap, refer to:

<http://www.dbalawyers.com.au/announcements/1-6m-balance-cap-examined-tax-death-benefits/>

Note: DBA Lawyers hold SMSF CPD training at venues all around. For more details or to register, visit www.dbanetwork.com.au or call 03 9092 9400.

For more information regarding how DBA Lawyers can assist in your SMSF practice, visit www.dbalawyers.com.au.

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