

#WC2019

# SMSFs and defined benefits pensions

## The ticking time bomb!

Mark Ellem, Executive Manager, SMSF Technical Services, SuperConcepts  
 Doug McBirnie, General Manager, Accurium






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### Mark Ellem

Mark holds the position of Executive Manager, SMSF Technical Services with SuperConcepts, providing technical and compliance support on SMSFs to financial advisors, accountants and SMSF trustees, as well ensuring that SuperConcepts' leading SMSF administration and compliance platform, SuperMate, is compliant with the latest superannuation and taxation rules.

An accredited SMSF Specialist Advisor with the Self Managed Super Fund Association, he is also a Fellow of CPA Australia and the Institute of Public Accountants (IPA), as well as being a Registered Tax Agent.

Prior to his current role with SuperConcepts, Mark spent considerable time in accounting practices and SMSF administration companies, including running his own accountancy practice and SMSF administration and compliance advice company for ten years.

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### Doug McBirnie

Doug is an experienced actuary and Accurium's General Manager. He is passionate about using his actuarial skills in the retirement space to provide innovative solutions for SMSF practitioners and their clients. As Accurium's senior actuary, Doug signs more actuarial certificates than any other actuary in Australia which provides him with great insight into the SMSF market.

Previously, Doug has worked as an actuarial consultant at a big four accounting firm providing advice to some of the UK's largest pension schemes.

Doug is a Fellow of both the Institute of Actuaries of Australia and the Institute and Faculty of Actuaries (UK) and has an Honours degree from the University Bristol. He lives in Hobart and loves the Tasmanian lifestyle, but still thinks rugby is better than AFL.

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## Agenda



- What are defined benefit (DB) pensions?
- Administering DB pensions
- What happens when DB pensioner passes away or pension expires?
- Pre-emptive strategies – commuting DB pensions
- Case studies




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## Background



- DB pensions are a promise to pay a defined income stream for a set term or lifetime
- Generally guaranteed by an employer or government
- Trusts (superannuation funds) used for advance funding to provide more certainty for beneficiaries in event of insolvency etc.
- Employer/guarantor usually still liable for any shortfall should funding prove insufficient to meet promised benefits
- Generally no link between benefits promised and performance of supporting assets
- DB pensions in SMSFs – don't fit the mould




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## DB Pensions in SMSFs



- Legacy DB pensions commenced prior to 1 January 2006
  - SISR 1.06(2) – Lifetime complying
  - SISR 1.06(6) – Lifetime non complying (flexi)
  - SISR 1.06(7) – Life Expectancy (fixed term)
- Member foregoes capital for right to income stream
  - Capital to commence pension transferred to 'Pension Reserve'
  - No balance to report against member
    - Financial Statements
    - Member Statement
- Concessional treatment in return for foregoing capital
  - Assets Test Exemption (ATE) for Age Pension
  - Beneficial treatment under Reasonable Benefits Limits




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### Camelot Superannuation Fund

#### Statement of Financial Position

For the year ended 30 June 2018

Note	2018	2017	
	\$	\$	
<b>INVESTMENTS</b>			
Australian Listed Shares	9	367,084	1,622,028
Australian Listed Unit Trust	10	116,252	98,466
Unit Trusts (Unlisted)	11	42,964	43,970
	<u>1,879,202</u>	<u>1,764,464</u>	
<b>OTHER ASSETS</b>			
Cash at Bank	12	13,053	15,511
Receivables	13	5,502	5,206
	<u>1,897,757</u>	<u>1,785,181</u>	
<b>TOTAL ASSETS</b>			
	<u>1,897,757</u>	<u>1,785,181</u>	
<b>LIABILITIES</b>			
Provision for Tax - Fund	14	(22,841)	(22,956)
	<u>(22,841)</u>	<u>(22,956)</u>	
<b>TOTAL LIABILITIES</b>			
	<u>(22,841)</u>	<u>(22,956)</u>	
<b>NET ASSETS AVAILABLE TO PAY BENEFITS</b>			
	<u>1,874,916</u>	<u>1,762,225</u>	
<b>MEMBERSHIP DEBT LIABILITY FOR MEMBERS' BENEFITS</b>			
Allocated to Members' Accounts	15	424,951	424,868
Not yet allocated	16	631,522	729,222
	<u>1,056,473</u>	<u>1,154,090</u>	

This Statement is to be read in conjunction with the notes to the Financial Statements

Capital to fund DB pension set aside in reserve - not allocated to member(s)

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### Camelot Superannuation Fund

#### Member Account Balances

For the year ended 30 June 2018

Member Account	Opening Balance	Transfer to the Fund (Contributions)	Transfer from the Fund (Withdrawals)	Less: Contributions Tax	Less: Member Expenses	Less: Administrative	Distributions	Closing Balance
<b>Member, Acc 01</b>								
<b>Member, Acc 02</b>								
<b>Member, Acc 03</b>								
<b>Member, Acc 04</b>								
<b>Member, Acc 05</b>								
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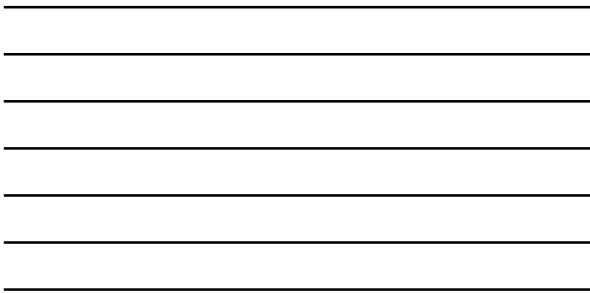
## Actuarial requirements

Annual requirement for a report from an actuary:

- Solvency valuation required under SIS Act – to ensure the fund has sufficient assets to meet the DB pension promise using 'best estimate' assumptions
  - No ability to add capital if insolvent – must commute pension
- 'High probability' valuation for pensions with ATE for Social Security purposes
  - Loss ATE if inadequately funded
- Actuarial certification under ITAA 1997 section 295-390 to provide income tax exemption (ECPI):
  - For an SMSF, Superannuation Liabilities generally equal to Net Assets
  - Tax exemption for DB pensions always less than 100% if pension is solvent

$$\text{Tax exempt \%} = \frac{\text{Average pension liabilities}}{\text{Average total liabilities}}$$

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### DB Pension - does reporting matter?

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**"Pension reserve account" = \$380k**

↓

"Investment reserve" - \$210k  
 "Mortality reserve" - \$60k  
 "Surplus amount" - \$110k

**"Pension account" = \$920k**

(Actuary's "best estimate liability" amount)

**"High probability" margin of \$270k**

- Total Pension Reserve = \$1,300,000
- Breakdown alters to reflect total capital backing 1.06(2) pension and actuary's calculations

- All represents amounts available to trustee and not to the member
- A "reserve" for reg 291-25.01 purposes
- Not considered a SIS reserve

SISR 1.06(2) Lifetime complying pension - ATO ID 2012/84 & 2015/22 & SMSFRB 2018/1

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### Payment of DB pension

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Member Account	
Opening balance	\$ Nil
Transfer from Pension Reserve	\$ 80,000
Pension payment	(\$ 80,000)
Closing balance	\$ Nil

←

Pension Reserve	
Opening balance - pension capital	\$1,300,000
Allocation to member to extinguish pension liability	(\$80,000)
Earnings on reserve	\$81,000
Closing balance	\$1,301,000

- Allocation from Pension Reserve to member is exempt from counting towards member's concessional cap due to reg 291-25.01(4)(b) ITAR

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### Pension exemption to concessional contribution cap

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Reg 291-25.01(4)(b)

- (i) the amount is allocated from a reserve used solely for the purpose of enabling the fund to discharge all or part of its liabilities (contingent or not), as soon as they become due, in respect of superannuation income stream benefits that are payable by the fund at that time; and
- (ii) any of the following applies:
  - (A) the amount has been allocated to satisfy a pension liability of the plan paid during the financial year;

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## Pension exemption to concessional contribution cap



- Exemption applies only to DB pensions
  - Capital held in reserve solely for the purpose of enabling the fund to discharge pension liabilities
  - Payment from reserve to discharge liabilities
- Will not apply to allocation from a reserve to fund an account based type pension (ABP or MLP)
  - The fund's liability is limited to the account balance
  - Payment from a reserve treated as allocation to ABP/MLP
    - Counts towards member's concession contribution cap
  - Recent ATO guidance – can't allocate from reserve to ABP




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Conduit Superannuation Fund  
Member Statement  
For the year ended 30 June 2018  
Member: JENNIFER  
My Name: Jennifer  
Address: 1/101 ...  
MARRIBONGH ...  
VIC ...  
AUSTRALIA ...  
Superannuation Member No: 1000000000

VEST OPENING BALANCE	1 JUL 2017	VEST CLOSING BALANCE
\$729,320.02	\$673,135.15	

**Life-time Complying Pension**

Member ID	1000000000
Member Name	JENNIFER
Member Address	1/101 ...
Member Date of Birth	10/10/1980
Member Pension	100%
Account Number	1000000000

**Opening Balance as at 01/07/2017** \$729,320.02

**New Contributions** \$162,000.00

**Closing Balance as at 30/06/2018** \$891,320.02

**ACCESS TO YOUR ASSETS**

Unlimited (no personal liability) available to the member  
Available on personal liability available when you have your employer  
Personal liability available when you have your employer (not including your personal liability)

**VEST TAX COMPONENTS**

Component	Value
Life-time Contributions	\$162,000.00
Life-time Withdrawals	\$0.00
Life-time Investment	\$729,320.02

**VEST INVESTMENT**

Joe Kennedy (Operator) 100%

## What's wrong with this picture?



- Pension is lifetime complying pension (SISR 1.06(2))
- Provides member with capital belonging to them
- Provide benefit paid in event of death (no lump sum death benefit for this type of pension)
- Includes a withdrawal benefit amount (non-commutable pension)
- Provides potentially misleading financial information to member and dependants
- Needs re-wording to note restrictions of this type of pension




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## Reporting TSB



Other transactions	Member opening or closing balance
S1 S Accumulator phase account balance	0 S
S2 S Retirement phase account balance	P S
S3 S Retirement phase account balance	Q S
CLOSING ACCOUNT BALANCE	R1 S
Accumulator phase value	R2 S
Retirement phase value	S S

- $TSB = S1 + S2 + TBA$  transactions for Capped Defined Benefit Income Streams (CDBIS); or
- $TSB = X1 + X2 + TBA$  transactions for CDBIS
- S3 not used as TBA transactions for CDBIS used
- What if capital for defined benefit pension is part of Pension Reserve - what is value at S3?

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### Do you have the documentation?



- Re Narumon Pty Ltd [2018] QSC 185
- Pension documents missing
- Was the pension reversionary?
- Did the (type of) pension exist?
- Legacy defined benefit pensions started pre 1 Jan 2006
- Do you know where the pension documents are?




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### What happens when a DB pension ends?



- For lifetime pension:
  - Pension liability ceases on death of pensioner or surviving reversionary pensioner
  - No superannuation death benefits payable
- For life expectancy:
  - Ceases at end of term
  - Can generally pay out value of remaining payments if pensioner dies before end of term
- Any remaining capital after pension ceases left in reserve
  - Superannuation benefits cannot be paid directly from reserve once pension ceases




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### Example 1 - Death of member with lifetime pension



Joe had lifetime complying pension, non-reversionary, no spouse, 3 adult children:

- Died 6 June 2018
- Balance of Pension Reserve @ death \$320k
- Balance of Account Based Pension (ABP) @ death \$50k (100% taxable component)
- BDBN in place → Estate
- What is paid out under BDBN?




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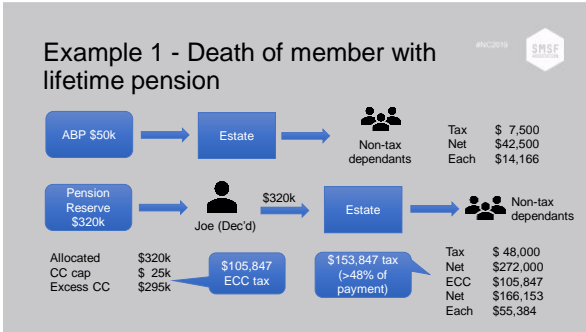
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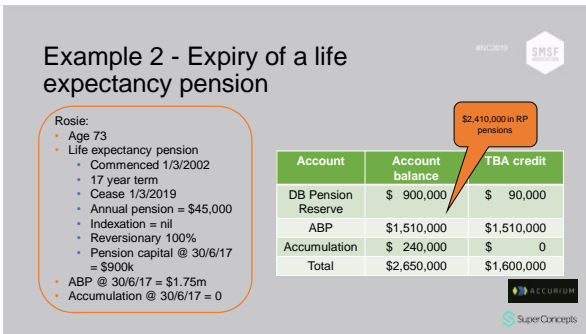
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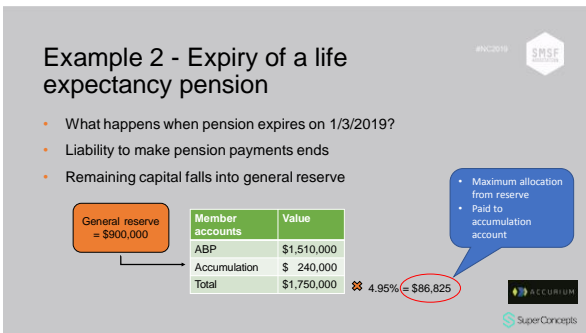
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## What can we do?



- Complying DB pensions (lifetime and life expectancy):
  - Can be only commuted to commence a new complying income stream:
    - Market-linked pension (MLP)
      - in SMSF or retail provider
    - Complying term annuity with life insurer
- Flexi pensions can be commuted to accumulation – use proceeds to start ABP (up to TBC)




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## Commuting DB Pensions



- Lifetime pensions
  - Can use all the assets supporting a complying lifetime pension (including reserves) to commence a new complying income stream
  - ATO ID 2015/22
- Life-expectancy pensions
  - SIS Regs – section 1.08 restricts the amount that can be commuted
  - Valuation factors in Schedule 1B in the SIS Regs

Commutation amount = MAX (Account balance, Pension payment x Valuation factor)

- Flexi-pensions
  - Same commutation restrictions as life-expectancy pensions




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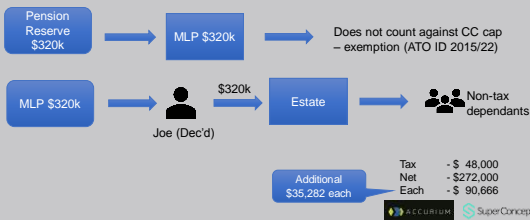
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## Example 1 revisited -Death of member with lifetime pension




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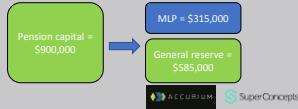
### Example 2 revisited - Expiry of a life expectancy pension



**Rosie:**

- Age 73
- Life expectancy pension
  - Commenced 1/3/2002
  - 17 year term
  - Cease 1/3/2019
  - Annual pension = \$45,000
  - Indexation = nil
  - Reversionary 100%
  - Pension capital @ 30/6/17 = \$900k
- ABP - \$1.75m @ 30/6/17
- Accum @ 30/6/17 = 0

- Option to restructure DB pension prior to 1/3/2019
- Maximum commutable amount:
  - \$45,000 x 7 = \$315,000




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### Example 2 revisited - Expiry of a life expectancy pension



Transfer Balance Account				
Date	Event	Credit	Debit	Balance
1/7/18	O/balance			\$1,600,000
1/7/18	Commute LEP (\$45,000 x 1)		\$45,000	\$1,555,000
1/7/18	Commence MLP	\$315,000		\$1,870,000
1/7/18	Partial commute ABP		\$270,000	\$1,600,000

Account	Value
ABP	\$1,510,000
MLP	\$ 315,000
Accum	\$ 270,000
<b>Total</b>	<b>\$2,095,000</b>

4.95% = \$103,700

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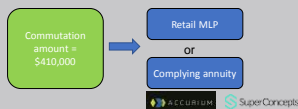
### Example 3 – Asset test exempt pension



**Jane:**

- Age 80 – widow
- 2 adult children
- Lifetime pension in SMSF
  - Commenced 1/1/2002
  - Annual pension = \$20,000
  - Indexation = nil
  - Non-reversionary 100%
  - Pension capital = \$410k
  - Assets Test Exempt
- Other assets = \$160k
- Receiving full Age Pension

- Concerned about reserves on death
- Considering winding-up SMSF to simplify finances
- Commute DB pension and rollover to new complying product:




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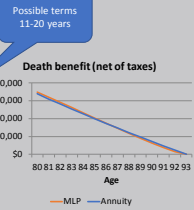
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### Example 3 – Asset test exempt pension

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	Current - Lifetime DB pension	Option 1 - Market-linked pension	Option 2 - Complying annuity
Term of complying pension	Lifetime	13	13
Annual complying pension payment (year 1)	\$20,000	\$43,800	\$38,600
Age pension entitlement (year 1)	\$23,800	\$0	\$20,300
Total income	\$43,800	\$43,800	\$58,900
Death benefit in year 1 (net of taxes)	\$216,100	\$348,500	\$338,000



**Assumptions:**  
 Net return of 5.7% p.a. plus admin costs of \$3,000 p.a. in SMSF. Maximum MLP payments taken each year. Annuity pricing based on Challenger complying annuity quote as at January 2018. Homeowner for Age Pension calculations. Income on non-super assets excluded from total income shown above and ECC tax estimates.

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### Transfer balance cap issue for restructure of DB pensions

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Commencing a MLP (from the capital commuted from a complying DB pension) with a market value in excess of the TBC?

- Not a CDBIS - commenced post 30 June 2017
- Not eligible for ATO's practical compliance approach
- Cannot utilise rules where 'special value' exceeds TBC
- MLP is still a non commutable pension → Excess cannot be commuted
- Excess pension balance continually in excess
- What now?




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### Transfer balance cap issue for restructure of DB pensions

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Unchartered territory but could mean:

- Notional earnings applied to excess at relevant rate
- 15% tax on those earnings each year (continuing first offence?)
- Fund gets to claim ECP1 on the entire balance
- If over 60:
  - member receives all pension payments tax free
  - defined benefit income cap does not apply.




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### Example 4 - MLP exceeds TBC



- Merlin, age 75, has a lifetime DB pension with \$4m capital
  - No other pensions
  - TBA special value credit 1/7/17 was \$2.56m
- Wants to restructure to MLP, 25 year term
  - Min MLP payment year 1 = \$240,000
- Benefits of restructuring DB pension to MLP
  - Annual pension payment not assessed against defined benefit income cap (50% of excess fully assessable @ marginal tax rate)
  - Better estate planning options




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### Example 4 - MLP exceeds TBC



Date	TBA event	Credit	Debit	Balance
01/7/17	Existing pension - CDBIS	2,560,000		2,560,000
22/2/19	Commutation of CDBIS		2,560,000	0
22/2/19	Commence new pension	4,000,000		4,000,000

- Issued with Excess TBC determination
- Need to commute the 'maximum available release amount'
  - = total amount of all lump sums that could be paid from that interest = nil (as non-commutable)
  - Pension will remain a 'retirement phase' income stream

Debit is equal to prior credit, less any debits in relation to the same pension




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### Example - MLP exceeds TBC



Positives	Negatives
<ul style="list-style-type: none"> <li>Claim ECPI on all income allocated to MLP (\$4m capital)</li> <li>Member can deal with interest from estate planning perspective - BDBN available; any residual on death belongs to deceased member</li> <li>No reserve left over on death to deal with under concessional cap rules</li> <li>Pension payment not subject to defined benefit income cap (50% of excess subject to MTR)</li> </ul>	<ul style="list-style-type: none"> <li>Notional earnings applied to excess TBC amount, subject to 15% tax (increase to 30%????)</li> <li>Cannot retain residual capital on death in fund for allocation to other members</li> <li>If an ATE pension for Centelink - no longer ATE</li> <li>If pre 1 July 2015 grandfathered pension for Centelink - no longer grandfathered. May lose entitlements, e.g. CSHC</li> </ul>




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## Conclusions

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- DB pensions can create significant issues with reserves when they cease
- Restructuring now can alleviate these
- Consider commuting to:
  - MLP to retain assets in SMSF
  - Complying annuity to retain Assets Test Exemption




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## Disclaimer

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