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Pensions: The past, the present and the future

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Introduction

With the introduction of the Transfer Balance Cap regime on 1 July 2017, there were a raft of super changes affecting SMSFs paying pensions, particularly impacting on a fund's ability to claim exempt current pension income (ECPI). This paper focuses on three significant changes that continue to impact on an SMSF's entitlement to ECPI from 1 July 2017.

- **Change 1:** A transition to retirement income stream (TRIS) is no longer an "eligible" pension balance for ECPI purposes until a member satisfies a condition of release with a nil cashing restriction. The result of this change is that only investment income generated from assets that support a TRIS in "retirement phase" is exempt from tax.

- **Change 2:** Some SMSFs are no longer able to use the "segregated" method to calculate ECPI whilst others must claim ECPI using the segregated method at any time (including parts of the year) when the fund has segregated current pension assets.

- **Change 3:** From 1 July 2017, an SMSF trustee is limited by the TBC in how much of a death benefit they can pay as a pension.

The paper also considers some of the challenges and opportunities that arise with the payment of pensions across members' different life stages, with a focus on:

- Pre-Retirement: Transition to Retirement Income Streams (TRISs)
- Retirement: Market Linked Pensions (MLPs)
- Death: Death Benefit pensions (DBPs)

In the interest of simplicity, this paper assumes that the ability of an SMSF to pay a pension is governed by the trust deed of the fund and adopts the use of the colloquial term 'pension' rather than 'superannuation income stream' as defined for super and tax purposes.

Pre – Retirement Pensions

Transition to Retirement Income Streams (TRIS)

From 1 July 2017, a TRIS is no longer an "eligible" pension balance for ECPI purposes until the recipient:

- reaches age 65; or
- advises the trustee that they have met one of the following SIS conditions of release:
  - retirement; or
  - permanent incapacity; or
  - terminal medical condition.

The result of this change is that only investment income generated from assets that support a "retirement phase" TRIS are exempt from tax.

In essence, with the introduction of the TBC on 1 July 2017 there are now two types of TRISs:

- A non retirement phase TRIS (an accumulation TRIS); and
- A retirement phase TRIS

A non retirement phase TRIS means it is in the accumulation phase, not the retirement phase. This means that the fund is not entitled to a tax exemption on the earnings. The preservation classification of benefits within the TRIS do not change and remain either preserved or restricted non-preserved. It is only once a condition of release with a nil cashing restriction is met that the commutation restrictions that apply to a TRIS are removed and the 10% maximum pension withdrawal limit no longer applies.

Once a member satisfies a condition of release with ‘nil’ cashing restriction the TRIS moves to the retirement phase and is reportable against the member’s transfer balance account (TBA) and the fund is entitled to the tax exemption on the earnings.

The TRIS will automatically move to retirement phase when the member reaches age 65, or if the TRIS starts to be paid to a reversionary pensioner after the original pensioner’s death. In other cases, such as the member’s retirement, becoming permanently incapacitated or meeting the terminal medical condition criteria, a TRIS will move to retirement phase when the trustee is notified of such.

A TRIS does not need to be commuted and restarted for it to move to retirement phase. Simply, the commutation restriction and capped pension withdrawals no longer apply.

The introduction of the concept of 'retirement phase' is specific to a fund's entitlement to claiming exempt income and is not specific to determining what is and is not an 'income stream'. This is an important distinction as both types of TRISs are still considered to be a pension and subject to the following:

- SIS Regulation minimum pension standards must be met.

  A fund that fails to meet these standards may be taken not to have paid a pension from the start of the income year in accordance with *TR 2013/5: When a superannuation income stream commences and ceases*. Where a non retirement phase TRIS was being paid, any benefits received that were not unrestricted non preserved benefits, will be treated as lump sums and fully assessable to the member as early access to superannuation benefits. Where a retirement phase TRIS was being paid, any claim to ECPI will be denied and the member’s transfer balance account will be impacted.

- On commencement of a TRIS, a new superannuation interest must be created.

  At the establishment of this new interest, the tax free and taxable components are determined. All benefits subsequently taken from the pension interest will be taxed based on the same proportion, which does not change. This applies to pension payments as well as lump sum commutations.

- Pension payments received are taxed concessionally.

  Any pension payments made to a member who is 60 or older will be tax free (i.e. non-assessable non-exempt income). The taxable portion of any payments made to an individual who has reached their preservation age, but is not yet 60, will be taxed at their marginal tax rate less a 15% tax offset.

- A reversionary TRIS does not cease when the member dies.

  If a TRIS is not reversionary, the TRIS will cease upon the member’s death whereas a reversionary TRIS continues to be paid and the entitlement to the payments transfers to the reversionary beneficiary. The

TRIS will be in retirement phase once it starts to be paid to the reversionary beneficiary, irrespective of whether the reversionary beneficiary has personally met a condition of release.

The reversionary beneficiary will receive a 'credit' to their transfer balance account 12 months after the date of the member's death. The amount of the 'credit' is equal to the value of the TRIS at the date of the member's death.

- Superannuation income stream (pension) continues

  When a TRIS moves to retirement phase, the income stream simply continues and there is no event which causes the TRIS to stop. This means that the trustee does not need to recalculate tax components nor is the trustee required to reset the pension drawdowns although the 10% maximum withdrawal limit will no longer apply.

  It is important to ensure that the balance supporting a non RP TRIS is reduced to within a member's TBC when it converts to a retirement phase income stream (RPIS). For a member under 65 there is an opportunity to manage this conversion however, the conversion of the TRIS into a RPIS is automatic on the day that a member turns 65 so planning ahead is required.

What is Retirement?

Post 1 July 2017 members with an existing TRIS or looking to commence a TRIS need to clearly understand what is required to meet the definition of 'retirement' as this is likely to be the most common condition of release which converts a non retirement phase TRIS into a RPIS.

There are two definitions of retirement which can apply depending on a member's age:
- the member has reached preservation age but not age 60
- the member has reached age 60 but not age 65.

Despite which definition applies, there is an intrinsic link to a member's preservation age. Essentially, unless a member has met their preservation age, it is impossible to meet the definition of retirement.

Retirement: Members of preservation age but under age 60

For this age group, a member is retired if they satisfy the following two elements
- an arrangement under which they were gainfully employed must end, AND
- the trustee is satisfied that the person never intends to become gainfully employed, either on a full-time or part time basis.

Reference to the definition of 'part time' confirms that a member must never intend to be gainfully employed for 10 hours or more per week at any time in the future. Where a client makes a genuine declaration that they do not intend to be gainfully employed again for 10 or more hours a week and their circumstances change, they can return to gainful employment without affecting their unrestricted non preserved benefits. All new contributions or benefits that accrue thereafter will be preserved until a new condition of release is satisfied.

What's noteworthy is that under this definition of retirement, it has been a long term interpretation of the industry that it is possible for a member to cease gainful employment at any reasonable time in the past. That is, there is no requirement for the gainful employment arrangement to end after preservation age or at the time that the member notifies the trustee of their intention to never be gainfully employed again for more than 10 hours a week.

However, with the publication of *GN 2019/1: Changes to transition-to-retirement income streams*, the ATO appears to have adopted a more restrictive view that requires a member to have ended an employment arrangement where they were under 60 years old, but over their preservation age in order to meet the first element of the definition of retirement for this age group. Further discussions with the ATO are necessary.

Retirement: Members aged 60 or more but under age 65

A member aged 60 or over can also satisfy the test above that applies for someone under the age of 60, alternatively they can simply satisfy the definition of 'retirement' if an arrangement under which they were gainfully employed ends on or after their 60th birthday, regardless of any future work intentions.

This means a member age 60 or over, can essentially return to work soon after ceasing their employment and still have met the condition of release of retirement to access all preserved and restricted non preserved benefits accumulated up until that time.

It also means that for a person who is working more than one genuine job, they can retire from one of those arrangements after they turn 60 and will still meet the definition of retirement despite continuing with their other arrangement, even if the remaining job had the greater number of hours and a higher remuneration. This is confirmed in *APRA's Prudential Practice Guide: SPG 280 – Payment Standard* which also states that any further superannuation benefits that's accrue after the condition of release is satisfied, will be preserved until such time as the member satisfies a further condition of release which can either be the termination of another employment arrangement or the member turning 65 years of age.

What is Retirement?

When you break down the definition of 'retirement', there is a need for a member to satisfy three elements in order to meet the definition of retirement:

- the member must be employed or self-employed; and
- the member must be in receipt of 'gain or reward'; and
- that arrangement must end.

These elements are not mutually exclusive and the onus is on the fund trustees to obtain whatever information is required in order to be reasonably satisfied that the member has retired. In practice, this is generally obtained via a declaration from the member covering each point relating to the member's employment status. When dealing with SMSFs the onus of proof is even greater with the ATO setting high expectations that as trustees and members, individuals should be well aware of the preservation rules and ability to access benefits under the retirement condition of release.

Future - Why bother with a TRIS these days?

Since the July 2017 reforms, TRISs have certainly lost some of their appeal having lost their tax exempt status unless they are in retirement phase. However, depending on a client's circumstances they may still present an opportunity when compared to retaining the monies in accumulation phase. For example:

- The balance of a TRIS is not limited to $1.6m as it is not tested against a member's TBC until it becomes a RPIS so there may be some opportunity to maximise tax effective super withdrawals:
  - For an individual that has yet to 'retire', they can still offer a mechanism to access some superannuation benefits, allowing them to draw a maximum 10% pension each year.
  - For those that are aged at least 60 years, these pension payments will be received tax free.
- Any surplus pension drawdowns can be used to fund further contributions to super as either:

  - NCCs to improve a member's tax-free component
  - Spouse contributions to maximise spouse equalisation opportunities
  - CCs (including available carry forward CCs) for the member to access a tax deduction

However, from 1 July 2017 there are some strategies traditionally used by pensioners, including those in receipt of a TRIS which are no longer available and these include:

- Before 1 July 2017, an election was available under reg 995-1.03 ITAR 1997 to convert a pension payment to a lump sum. This election was often used by those under 60 and in receipt of a TRIS to get access to preserved super benefits, although they still had to comply with the maximum annual 10% pension limit.

  Essentially, the TRIS pension payment would be excluded from income and instead, the member could access their lump sum low rate cap. From 1 July 2017, the election to treat a TRIS payment as a lump sum was repealed. Members can no longer access preserved benefits from a TRIS and therefore members under 60 will generally no longer be able to access their low rate cap from a TRIS.

- A commutation from a TRIS is possible, provided the member has unrestricted non-preserved benefits within the pension. A commutation of a TRIS will result in a lump sum which does not have to be in cash and can be paid in-specie by way of a transfer of an asset.

  Pre 1 July 2017, a partial commutation from a TRIS counted towards satisfying the minimum pension drawdown requirements. However, since 1 July 2017, partial commutations no longer count towards satisfying the minimum pension requirements, so this means that at least the minimum pension has to be paid in cash. This aligns with the long standing ATO view that a pension payment must be a cash payment and that only lump sums can be made in-specie.

RETIREMENT PENSIONS

ECPI PROVISIONS

The primary change from 1 July 2017 relates to super funds deriving ECPI only on assets supporting a pension in retirement phase. However, SMSF were impacted further with some SMSFs no longer able to use the segregated method in some circumstances whereas other SMSFs are now required to claim ECPI using the segregated method.

These changes do not limit members of an SMSF making individual investment choices. Equally, SMSF trustees are free for investment purposes to maintain different pools of assets as a consequence of those investment choices made by members. In other words, "segregation" for investment and asset allocation purposes continues to be acceptable.

Segregated method NOT available

From 1 July 2017, SMSF trustees are prohibited from using the segregated method for tax purposes where they have 'disregarded small fund assets'(DSFAs). In essence, an SMSF will not be able to use the segregate method to calculate ECPI where, at the previous 30 June:

- any member of the SMSF had a TSB > $1.6m (across all of their super interests combined), AND
- that member was in receipt of a RPIS from any fund (not necessarily the SMSF).

This applies even where SMSF trustees have set aside specific assets to solely support retirement phase pension accounts or where the only balances in the fund are 100% supporting retirement phase pensions.

These SMSFs are not prevented from claiming ECPI but rather they are required to calculate their ECPI using the proportionate method which requires obtaining an actuarial certificate.

For SMSFs 100% in retirement phase, trustees may wish to consider starting the pension as soon as possible in a particular financial year to ensure a higher proportion of exempt income.

For SMSFs with retirement phase and accumulation interests, trustee may wish to consider the following in trying to optimise the % of ECPI.

- Start RPIS as early as possible in a financial year so it's in place for as long as possible and draw pension requirements as late as possible in the financial year.
- Draw amounts in excess of minimum pension requirements from the accumulation account to maximise the balance of assets supporting a RPIS.
- If receiving contributions, consider accepting contributions in the later months of the financial year.

Segregated method MUST be used

This change, effective on 1 July 2017, is not a law change but comes following clarity from the ATO on the operation of the law. The ATO view requires a SMSF to claim ECPI using the segregated method at any time (including parts of the year) when the fund has segregated current pension assets.

Recognising wide industry practice, the ATO agreed to apply their view only from 1 July 2017.

Where trustee's actively segregate and specifically identify & set aside assets to fund a pension the ATO view has little impact on long standing industry practice. However, where funds are 'deemed' to be segregated because all of the fund assets are supporting current pension liabilities, it means that SMSF trustees are required to calculate ECPI based on distinct periods over a financial year, even where they have accumulation interests throughout the year.

SMSF trustees may wish to consider the following in trying to optimise the proportion of ECPI in these circumstances:

- Where contributions are expected, consider accepting as late as possible in the financial year.

- Trustees can choose to set aside specific assets to support new contributions and by default the remainder of the SMSF assets continue to solely support a RPIS and are considered 'segregated' pension assets for the purposes of calculating ECPI. The ability for the trustee to specifically set aside assets to solely support "non-current assets" (i.e. accumulation balances) is still subject to the DSFA test.

Industry is currently awaiting legislative changes to deliver on the Government's proposal to streamline ECPI calculations, first announced in the 2019 Budget. These changes are expected to:

- Remove the need to get an actuarial certificate for SMSFs caught by the DSFA rule but solely funding RPISs. This would reinstate industry practice pre 1 July 2017; and

- Allow SMSFs to use the actuarial method to calculate ECPI for a whole financial year, despite having deemed segregated assets for part of the relevant year.

Commutations

When commuting an account based pension, it is important to refer to the ATO's view, as expressed in *TR 2013/5 Income Tax: when a superannuation income stream commences and ceases*, which confirms that under a partial commutation, the pension will continue as contrasted with a full commutation where the pension ceases.

Where a pension is fully commuted, it is the ATO's view that the pension ceases before the time the lump sum payment is made to the member. In essence, TR 2013/5 paragraphs 23-26 confirm:

- the commutation(s) will occur first,
- a full commutation causes the pension(s) to end, and consequently
- the assets would cease to be pension assets, followed
- by the lump sum payment / rollover.

This means that where the full commutation lump sum payment is made by way of an-specie asset transfer(s), the "disposal" for CGT purposes occurs when the asset is no longer supporting a pension. Rather it will occur in a distinct and separate accounting period and will be fully taxable.

Furthermore, where a pension is fully commuted, Reg 1.07D requires a pro-rata min pension payment to be paid prior to the ceassation of the pension to ensure that the pension is not at jeopardy of failing the minimum pension standards.

The alternative is to consider *partially* commuting a pension as the assets do not 'cease' to be current pension assets. In essence:

- income generated after the partial commutation would remain completely exempt from tax
- capital gains from any in-specie asset transfer would be disregarded

The minimum pension requirements must still be met and must either be paid before a pension is partially commuted, or there must be sufficient balance remaining after the partial commutation for the minimum pension payment to be drawn.

It is often considered best practice to partially commute the majority of a pension account and ensure that the last payment is a pension payment.

Where a commutation is a lump sum withdrawal from a RPIS, a member will also benefit from a corresponding 'debit' in their TBA. This has the potential to create space in their TBC should they have the capacity to add further capital towards a RPIS in the future.

Market Linked Pensions (MLPs)

A decade after SMSFs were no longer able to start a new MLP with a members' accumulation benefits the introduction of the TBC has introduced new challenges for those funds with a MLP or considering restructuring into a MLP for a number of reasons such as:

- resetting the term (and therefore changing the pension amounts), or
- adding or removing a reversionary beneficiary, or
- re-structuring a legacy pension such as a complying lifetime, complying life expectancy or flexi pension, or

- moving to a different provider, perhaps wishing to wind up their SMSF.

Where a MLP was being paid just before 1 July 2017, the MLP will fall within the definition of a 'capped defined benefit income stream' (CDBIS) for TBC purposes. This means that the:

- the 'credit' value of the pension is based on a formula instead of the value of the underlying assets. In many cases the 1 July 2017 special value was higher than the account balance of the MLP; and

- a member in receipt of a MLP of more than $100,000 p.a is required to pay tax on 50% of the income over $100,000, at their marginal rate (MTR). Prior to 1 July 2017 a member over the age of 60 receiving an MLP would not have paid any tax.

What it also means is that, despite the introduction of the $1.6m TBC, the total balance of a pre 1 July 2017 MLP can be retained within the retirement phase cap. In essence, a pre July 2017 MLP will not give rise to an excess transfer balance despite the MLP balance exceeding the $1.6m limit provided the member does not have any other retirement phase income streams from which they could remove the excess to reduce the amount in retirement phase.

Where a MLP commences from 1 July 2017, the 'credit' for TBC purposes is based on the account balance of the pension at commencement. This applies to any new MLP or restructured MLP.

Members considering restructuring a MLP post 1 July 2017 need to proceed cautiously as there is currently a flaw in the law when determining the value of the TBC 'debit' that arises on commutation. Under the current law, the value of the commutation 'debit' is Nil. As there is no 'debit' to offset the 'credit' which arises when the new MLP commences, benefits are effectively double counted and increase the risk of a breach of the $1.6m TBC. Should an excess arise, as the MLP is non commutable, there is no way of removing the excess and the member is at risk of being perpetually in excess.

In recognition of the unintended consequences associated with the current law for determining the 'debit' value, the ATO has confirmed it will not take compliance action at this stage if an SMSF:

- does not report the commutation event or the start of the new MLP for TBA purposes, or
- reports the commutation TBA 'debit' value other than 'nil'.

Draft legislative currently before parliament proposes to fix the 'debit' value issue to ensure that there is a 'debit' to a member's TBA where a MLP is fully commuted. However, the proposed law fix 'debit' value is still expected to differ from the underlying account balance, giving rise to a discrepancy with the 'credit' value that is reported on the commencement of the new MLP. As the proposed law is set to apply retrospectively to commutations from 1 July 2017, it is difficult to plan until the law is passed confirming the special value 'debit'.

DEATH BENEFIT PENSIONS (DBPs)

Cashing rules

From 1 July 2017, an SMSF trustee is limited by the TBC in how much of a death benefit they can pay as a retirement phase pension.

Where the SMSF trustee is able to cash the deceased member's benefits as a DBP, the cashing requirement is continually met so long as the RPIS continues to be paid. This can be until such time as the pension is exhausted or the beneficiary commutes the income stream and the resulting lump sum is paid out of the super system. This means that a DBP:

- Cannot be rolled back to accumulation; and
- Cannot be mixed with the beneficiary's other superannuation interest(s) at any time.

With respect to death benefits, an exception applies from 1 July 2017, to allow the cashing rules to continue to be met where a member opts to rollover a death benefit, including a pension to a new fund. Provided that the death benefit rolled over is not left in the accumulation phase in the new fund and instead is used to fund a death benefit income stream or is cashed out as a lump sum as soon as practicable, the cashing requirements will be met.

Failing pension standards

Where a superannuation death benefit is paid as a pension, the ATO view is that the cashing requirement is continually met so long as the retirement phase pension continues to be paid (*LCR 2017/3: Superannuation death benefits and the transfer balance cap*). In accordance with TR 2013/5, for a pension to continue, the trustee must ensure that the minimum pension standards are constantly met.

TR 2013/5 equally applies to DBPs and a common circumstance where a pension may be taken to have ceased, is where the minimum pension payment in a financial year is not paid to a member. Notable, the minimum pension drawdown requirements in the year of the primary pensioner's death differ, depending on whether or not the pension was reversionary:

- Where an account based pension was non reversionary, the pension 'ceases' on the member's death and there is no need to pay any pension payments post death. Should a new death benefit pension commence, fresh minimum drawdowns will be calculated based on the eligible recipient's age and the value of those assets at the start of the pension.

- Where an account based pension is reversionary, the trustee continues to have an obligation to pay the annual minimum pension drawdown, as determined on 1 July, in the year of death. This is because the pension does not cease on the death of the primary pensioner.

Where an SMSF doesn't pay the required minimum pension payment requirements, the death benefit pension will be taken to have ceased at the start of the financial year (TR 2013/5). This means that from the start of that financial year, the member's superannuation interest will no longer be supporting a pension.

Instead, any payments made during the financial year will be treated as superannuation lump sums for both income tax and superannuation purposes. From 1 July 2017, every single superannuation benefit that arises from the death of a member will ***always*** be a superannuation death benefit. Therefore, multiple lump sum payments that exceed the maximum two limit lump sum cashing restriction, will be a breach of the compulsory cashing requirements. This is not a breach that a trustee can fix.

Where the pension underpayment is small, or the result of an error, the trustee may be able to self-assess to apply the ATO's general powers of administration to treat the fund as having continuously paid the pension, despite the underpayment. Where a trustee does not meet the required conditions to self-assess access to this exception, they need to apply in writing to the Commissioner. If the exception can be applied, the fund will not be taken to have breached the SIS Regs.

Can the SMSF trustee resolve the breach?

Although it is not possible to fix the breach resulting from the fund's failure to meet the compulsory cashing requirements, the ATO accepts that trustees can prevent future contraventions by acting swiftly after becoming aware of the breach.

The ATO also accepts that an SMSF trustee can meet the 'as soon as practicable' requirement on a go-forward basis in the limited circumstance where the trustee fails to meet the minimum pension requirements and the DBP has stopped.

The ATO accepts that the superannuation death benefit could still be considered cashed 'as soon as practicable' by cashing the benefit:

- as a new death benefit pension in retirement phase, or
- as a lump sum (limited by the maximum two payments); or
- by rolling over to a complying fund for immediate cashing as a new death benefit pension.

Where a DBP is unable to be paid or no longer preferred then the compulsory cashing requirement could only be met by the payment of a lump sum. Where the resulting final lump sum death benefit would breach the maximum 2 lump sum limit, recent discussions with the ATO have confirmed that the Regulator would not apply compliance resources on the application of 6.21(2)(a) of the SIS Regs, provided the event was carried out in good faith.

Where the trustee commences to pay a new DBP immediately and then continues to make the payments for that pension under its rules, the ATO accepts they will meet the requirement of cashing 'as soon as practicable' because each one of those payments will come out as soon as they practically should under the pension's rules.

From a practical perspective, it is important to ensure that the following apply with respect to the new DBP:

- ECPI is denied in relation to the relevant interest from the start of the relevant financial year until the time the new pension is commenced.
- The separate interest supporting the death pension now ceased, will need to be maintained to ensure that the death benefits do not mix with the beneficiary's other superannuation benefits.
- The tax components of the new pension interest will be reset at commencement.
- The TBC 'Dr' for a failure to comply with the SIS pension standards only arises at the end of the year of the underpayment (i.e. from the time it is possible for the trustee to determine the fund had failed those standards which would be 30 June.)
- It is possible to commence the new DBP within the same SMSF or a member can rollover to cash immediately as a new DBP in an alternate fund.

Life Interest Pensions (LIPs)

Life interest pensions (LIPs) are not a new concept with the primary uptake from members with blended families. The main purpose behind these pensions is to provide a pension to a spouse, typically the second spouse of the deceased for their lifetime with any remaining pension capital thereafter going to the deceased's children, including those from their first marriage.

Traditionally, the sector has treaded cautiously when considering the suitability of a LIP given the uncertainty around whether or not the cashing rules in the SIS regulations were satisfied. Reference to SIS Reg 6.22 limits the cashing of a super death benefit to a member's legal personal representative and/or one or more of the member's dependants. A LIP raises the key question that upon the death of the DBP recipient, do the terms "member's benefits", "member's legal personal representative" and the "member's dependants" only refer to the beneficiary or can they also refer to the initial deceased member?

The conservative view to date has been that upon the payment of a DBP to a beneficiary, the benefits belong to the new pensioner so upon their death, the benefits can only be paid to their dependants or LPR. However, reference to *PCG 2017/6: Commutations of a death benefit income stream before 1 July 2017* confirms that despite how long a beneficiary is in receipt of a DBP, they are unable to treat any residual amount on commutation as their own superannuation interest. In essence, the ATO view is that once a death benefit, always a death benefit. This clarity has shifted many to a reasonably arguable conclusion that reference to a 'member' for the purposes of the SIS cashing regulations could include the original deceased member.

A further question raised by a LIP relates to when the death benefit is taken to be 'cashed' and whether there is a breach to the 'as soon as practicable' requirements of SIS reg 6.21. Reference to LCR 2017/3 provides some clarity on the ATO's view on the operation of the compulsory cashing requirements, confirming that the 'as soon as practicable' requirement is not breached for as long as a death benefit income stream is payable. It also confirms that in order to satisfy the cashing rules, unless the capital of the pension is exhausted, any remaining benefits will always be treated as a death benefit of the original deceased member.

Besides the technical issues discussed there are practical issues which need to be considered. These issues primarily relate to the ability of the beneficiary to access the capital of a LIP before their death. This could be done in a number of ways, including:

- by commuting the pension and taking the capital as a lump sum;
- calling for 100% of an account based pension to be paid in a particular year;
- amending the deed and pension documents to remove the requirement to pay the remaining capital to the initial member's dependant or legal personal representative (LPR);
- rolling over the LIP to another fund to commence a new pension without such restrictions.

Please note that the above view not been tested with the ATO. This is a very complex area and it is strongly recommended you seek appropriate legal advice and make sure you have properly executed documentation in place to ensure that the death benefit can effectively be paid in 2 parts.

Insurance

As a general rule insurance proceeds are not assessable income of the SMSF. The proceeds are not income according to ordinary concepts and are specifically excluded from capital gains tax. Furthermore, the proceeds are not a contribution and are instead treated like income or earnings (*TR 2010/1: Superannuation contributions*).

When allocating insurance proceeds, it is important to allocate in accordance with SIS Reg 5.03 on a "fair and reasonable" basis. In the context of insurance proceeds, the proceeds should be allocated directly to the insured member's account. Where the member has more than one account (e.g. accumulation and pension inetersts), the ATO view is that proceeds should be allocated to the account from which the premiums were deducted.

On allocation of the insurance proceeds it is relevant whether the deceased member was in accumulation or pension phase. Where the deceased was in accumulation phase, the proceeds must be allocated to their accumulation interest and will add to the member's taxable component (ITAA 1997 s.307-125). The tax free and taxable components of a subsequent death benefit will be determined at the time of 'cashing' (pension or lump sum).

Where the deceased was in pension phase and only an account based pension interest exists, proceeds should be allocated to the superannuation interest supporting the pension. Insurance proceeds can be allocated directly to pension accounts as SIS only prohibits allocations to pension accounts by way of contribution or rollover (SIS Reg 1.06(1)(a)). (TR 2010/1 para 138).

Where the DBP is a reversionary pension, the pension simply continues and insurance proceeds are added to that account. Essentially:

- Insurance proceeds are split based on the original tax free and taxable components of the deceased member's pension. This split will apply to any lump sum from the reversionary pension but as it retains its death benefit status, it will always be received tax free by a dependant, despite the split.

- On the reversionary's death, the death benefit payable retains the same proportions.

- Typically, insurance proceeds are received after the date of death which is later than the reportable 'event' date for TBC purposes. Therefore insurance proceeds are unable to form part of the account balance that is reported in a member's TBA.

- The SMSF continues to be exempt from tax on the earnings attributable to those pension assets, including earnings on insurance proceeds.

Where a DBP is paid from an account which did not automatically revert the pension ceases on the death of the primary pensioner and:

- Modified proportioning rules apply where amounts other than investment earnings are added to the pension account post death (ITAA Reg 307-125.02). Essentially, insurance proceeds are included in the taxable component.

- Any lump sum death benefit paid will be based on the new proportions established at the start of the death pension but death benefit status is retained, so received tax-free by a tax dependant.

- On the beneficiary's death, the death benefit payable retains these proportions.

- For TBC purposes, a transfer balance account 'credit' arises when the new DBP commences. Where the pension includes insurance proceeds, they will be included for TBC purposes.

- For ECPI purposes, despite the pension ceasing on death, the earnings on the assets supporting the pension continue post death subject to the SIS cashing requirements. However, the tax exemption is reduced where amounts other than investment earnings are added to the pension balance after the pensioner's death, such as insurance proceeds. The amount of insurance proceeds and any attributable earnings are excluded from the pensioner's balance for the purposes of ECPI calculations.

Death Benefit Pension (DBP) rollover

From 1 July 2017, pensions can be rolled over to a different superannuation provider. This change extends to a DBP and simply requires the eligible beneficiary to commence a pension immediately in the new fund to ensure the cashing rules are continually met.

In order to allow the rollover, the DBP will be commuted and the resulting lump sum death benefit will be rolled over. This will trigger the application of sec 307-290 ITAA97 to create an untaxed element where the fund has claimed deductions for insurance in relation to the death benefit. As the law is currently drafted, the untaxed element on rollover will be included in the assessable income of the new fund receiving the rollover. This consequently reduces the amount of the gross benefit originally available to the beneficiary to fund a new DBP.

In Dec 2019, draft law was introduced to specifically exclude an untaxed element created by a death benefit rollover from being taxed in the receiving fund with a retrospective application date of 1 July 2017. This is a long overdue fix however, it only proposes to fix the taxing point at the fund level and does not address the different tax outcome at the member level.

For example, a beneficiary in receipt of a death benefit pension from the original fund would have no untaxed element and would either receive the pension tax free or benefit from a 15% tax offset, depending on their age. Whereas the same pensioner could opt to rollover their death benefit pension (avoid tax as proposed on rollover) but would still have an untaxed element created which means that their future pension payments would have an assessable component with a max. 10% tax offset available where the deceased or beneficiary is aged under 60. This result is a very different tax outcome and ultimately changes the tax treatment of a beneficiary's DBP, based on the fund it is paid from.