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Ending pensions in 2017/18 and beyond – both new and old paradigms

While most SMSF advice about pensions is focussed on *starting* them, pensions also end sometimes. In this edition of Super Insights we cover some of the nuances around the ending of pensions under five common scenarios. Some of these nuances have applied for many years but some are new for 2017/18 and beyond.

FIVE SCENARIOS FOR ENDING PENSIONS

In this article we focus on account-based pensions and transition to retirement income streams (TRIS) only although many of the comments also apply to other income streams such as market linked (term allocated) pensions and defined benefit pensions.

Account balance reaches $nil

Sometimes there is no explicit decision to end a pension, it simply ends because the pension account runs out of money. This is common in SMSFs where (say) a member takes a large payment and divides it between several different pension accounts but does so in a way that means any small pension accounts are completely depleted.

A pensioner leaves the fund

When a member leaves the SMSF and their balance is transferred to another fund (or paid out in full), any pensions in place will naturally end. This is because a pension cannot be rolled over "intact" – the pension must be commuted to a lump sum and the lump sum can then be rolled over. This also includes on windup of the fund where all members are effectively paid out or transferred to another fund.

Member chooses to end the pension

Sometimes pensions end because the member decides he or she has no further use for it. Scenarios which will be common post 1 July 2017 include:

- A member who inherits a pension from a deceased spouse may voluntarily end their own pensions to create sufficient "cap space" to comply with Transfer Balance Cap requirements.
- A member who no longer requires their TRIS and decides to terminate it now that it no longer generates tax benefits in the fund (many TRIS recipients did this on/around 30 June 2017).
- A member receiving a TRIS who is about to retire or reach age 65 and needs to restructure their pensions to fall within the $1.6m Transfer Balance Cap. In some cases, the restructuring will involve terminating the original pension(s) entirely.

Member receiving a non reversionary pension dies

Even if the surviving spouse or other eligible beneficiary ultimately takes the remaining balance as a new pension, the original non reversionary pension technically "ends" as a result of the pensioner's death.

Fund fails to pay the minimum pension over a financial year

There are some special rules under which a small underpayment will be forgiven (once) but the general principle is that failing to meet the minimum payment requirements will trigger the cessation of the pension **for income tax purposes** from the start of the financial year.

Each of these scenarios creates different challenges. For this reason, we detail below our tips for making sure the ending of a pension does not result in adverse consequences for your clients.

TIP #1 – AVOID ENDING A PENSION WITH A FULL COMMUTATION, OR MINIMISE ITS IMPACT

"Commutation" is the name given to the process by which a member consciously and validly exercises their right to exchange some or all of their entitlement to receive future superannuation income stream benefits for an entitlement to be paid a lump sum [TR 2013/5 para 110]. A pension can be fully commuted (ie the pension ends) or partially commuted (ie the pension remains but with a lesser amount payable).

One of the challenges with a full commutation is that the pension is deemed to end as soon as the request from the pensioner to "fully commute their future entitlements to future superannuation income stream benefits for an entitlement to a lump sum" takes effect [TR 2013/5 para 23]. Broadly speaking, in an SMSF this will be:

- At a specific future date requested by the pensioner and agreed to by the trustee, or
- If no date is specified, as soon as a valid request from the pensioner is accepted and agreed by the trustee.

Importantly, this will always be ***before*** the payment arising from the commutation is made – eg a cash payment to a beneficiary, the transfer of assets to a beneficiary or the transfer of cash or assets to another superannuation fund (as part of winding up a member's interests or the entire fund).

This creates some nasty traps.

Premature end of ECPI

The fund's exempt current pension income or ECPI calculation (the tax exemption available to some or all of the investment income earned by funds paying retirement phase pensions) will end *at the date of the commutation* rather than *when the payment is made*. This is particularly relevant if the commutation results in assets being transferred to a member or another fund (eg winding up a fund and transferring assets in specie) as it means any capital gains on the assets will be realised *after* the ECPI has ended!

We traditionally manage this trap by ensuring that pensions do not end with full commutations where assets are to be transferred in specie. Instead, we treat the major asset transfer as a *partial commutation*. Partial commutations do not cause the pension to end and hence the CGT event that occurs when assets are transferred out of the fund will occur while the fund is still entitled to ECPI. A full commutation could occur later when any remaining transfers or payments are to be made in cash. Alternatively, depending on the circumstances, it may be possible to have the pension end with a pension payment rather than a commutation.

One increasingly common scenario under which pensions can end via a full commutation "by accident" is where standard documentation is prepared to record any payments over the minimum payment requirements as commutations from a member's pensions. (This is an attractive strategy as commutations "add back" ie create "cap space" in the pensioner's Transfer Balance Account.) Particularly when a member has multiple pensions, a large payment can inevitably result in a small pension account being reduced to $nil without any conscious action by the trustee or member.

In our documentation, we have addressed this to ensure that no commutation shall ever cause the pension account to fall to $nil.

As an aside, it is worth noting that prior to 1 July 2017 even a partial commutation could result in some loss of ECPI in some situations. This was particularly problematic if assets were transferred from the fund in specie as part of the partial commutation. However, as part of the 1 July 2017 Superannuation Reforms, this problem has been fixed. A partial commutation is now treated as a superannuation lump sum for all purposes except the provisions dealing with ECPI – for those provisions it is treated just like a pension payment meaning it does not affect ECPI at all [ITAA 1997 s 307-65(2)].

Minimum pension issues

The payment made as part of a full commutation will be made after the pension has ended and will therefore not count towards the minimum pension requirements for the year (see Tip #2 below).

TIP #2 – MAKE SURE MINIMUM PAYMENT REQUIREMENTS ARE SATISFIED BEFORE THE PENSION ENDS

Superannuation law requires a minimum payment to be made every year from any pension. The minimum is calculated on a financial year basis but is pro-rated where the pension ends mid year. As an example, if a pension ends on 31 December roughly half the full year's minimum would need to be paid before the pension ends.

The one exception is pensions that end because the pensioner died and the pension was non reversionary (this is explained in our blog "Does the minimum pension need to be paid in the year the pensioner dies?").

For all other pensions, paying the minimum before the pension ends is critical. If this is not done, the pension will be deemed to have ended for income tax purposes at the start of the financial year (just like a pension that remained in place and underpaid the minimum over the full financial year).

This sounds quite simple – where are the traps?

- As mentioned above, any payment made as a result of a full commutation does not count towards this minimum as it is a payment that is made after the pension has already ended.
- In fact from 1 July 2017, a payment made via the partial commutation of a pension doesn't count towards the minimum payment requirements either [SIS Reg 1.06(9A)(b)(i)(B)]. Hence it is important to carefully check that payments earlier in the year were actually superannuation income stream benefits that count towards the minimum. Even where a pension ends because the account balance reaches $nil due to a pension payment, advisers must ensure that (say) not too much has been treated as a partial commutation earlier in the year.
- It is easy to forget this requirement when the monies remain in the fund (eg a full roll back to accumulation because the member no longer wants the pension or to terminate a TRIS shortly before the member's retirement).

TIP #3 – WATCH THE TIMING OF YOUR TRANSFER BALANCE ACCOUNT REPORTING

There is no reporting required if a pension account simply reduces to $nil as a result of pension payments (superannuation income stream benefits). The fact that a pension has ended in this way does not change the fact that the pensioner has used up some or all of their Transfer Balance Cap.

In contrast, both partial and full commutations are reportable to the ATO because they "add back" to a member's Transfer Balance Account. Remember that SMSFs have different reporting deadlines to large superannuation funds and this can create another trap. A common scenario might be:

- A member had a $950k retirement phase pension in place in an SMSF at 30 June 2017.
- This balance is reported to the ATO on or before 2 July 2018.
- The member is the sole member of the SMSF and has no other superannuation.
- In December 2018, the pension is fully commuted and rolled over to a retail fund where it is immediately used to start a new pension.
- By the time the rollover occurs, the pension balance has grown to $1.1m.

The member clearly should not have an excess relative to the $1.6m Transfer Balance Cap – they have always been comfortably within this limit.

However:

- the SMSF is not obliged to report the December 2018 commutation (a $1.1m reduction in the member's Transfer Balance Account) until the 2018/19 Annual Return is lodged (which could be as late as May 2020), but
- the retail fund must report the December 2018 commencement of the new pension no later than 10 business days after 31 December 2018 (ie 15 January 2019).

If the SMSF does not report the commutation early (in fact, before 15 January 2019) the ATO will conclude that the member has exceeded the $1.6m Transfer Balance Cap as the only information available to them will be the original $950k pension and the commencement of the new $1.1m pension.

Remember that this type of reporting event is likely to be very easy for the SMSF to report – the amount of the commutation will obviously be known as money/assets equal to that amount will have been transferred to the new fund.

CONCLUSION

Managing the end of a pension has always required some careful handling. Some challenges of the past have been reduced post 1 July 2017, while new issues have emerged.

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