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NEWS

Dec 2010

Reversionary pensions

A pension may be made 'reversionary' to certain dependants (eg, a spouse or child under 25 years). A reversionary pension may have certain advantages compared to a non-reversionary pension. This article focuses on the key features of reversionary pensions and highlights some planning tips and traps.

Making a pension reversionary

The documents establishing a pension may include a reversionary nomination — which is a request that the trustee continues to pay a member's pension to their dependant following the member's death. This nomination is typically found in the trustee resolutions establishing the pension or, if the deed does not contain pension provisions, in a pension agreement that does.

A pension that is reversionary from the outset is also called an 'auto-reversionary' pension (ie, it automatically reverts on the member's death to their reversionary beneficiary).

Non-reversionary pensions

In many cases, a pension is set up as non-reversionary with the SMSF trustee having a discretion (in the deed) to revert a pension on death. Most pensions set up prior to mid 2007 were made non-reversionary as the tax rules that then applied generally made reversion inefficient.

The issue that these people may face is that on the member's death, the pension which was not made expressly reversionary prior to death may well be considered to have stopped and the proceeds (internally) rolled back into accumulation.

This can easily happen as the family may be left grieving following the loss of a loved one and time ticks by without any action being taken including the payment of the minimum pension amount for the financial year prior to 30 June.

The ATO might take the strict view that the pension exemption ceases on the death of the pensioner unless the pension is capable of reverting to an eligible beneficiary: see ATO ID 2004/688.

Thus, a number of practical traps can readily present themselves unless an auto reversionary pension is in place.

Note that pensions can be made reversionary after a pension is established either while someone is alive or on their death (assuming the documents governing the pension are flexible).

Tip: You should check to see whether your pension is reversionary. If it is, you should check to see that the nominated person is eligible to receive such a pension, eg, a child 25 years or more is generally not eligible. If the pension is not reversionary, then you should consider making it expressly reversionary.

Requirements on death

If a pension is commuted on a member's death, there is no requirement to make a minimum payment for that financial year (see: reg 1.07D of the *Superannuation Industry (Supervision) Regulations 1994* (Cth) ('SISR')). However, if the pension reverts, there is a requirement for the minimum pension amount to continue to be paid before the end of each 30 June.

If the requisite minimum pension amount is not paid prior to 30 June, the ATO may consider the pension exemption for the fund for the entire financial year is lost.

In many cases there can be a significant delay between a member's death and the actual paperwork being put in place to confirm the reversion of a pension. In addition, in some of these cases the full minimum annual payment has not been paid. In these cases, the ATO may seek to argue that the pension was commuted on the member's death and the pension exemption also ceased at that time.

This trap exists particularly in a situation where the remaining members or executors of the deceased's estate delay taking action to make sure the deceased's superannuation entitlements are being appropriately managed. While the death of a family member is an emotional time for families and this can result in other matters being overlooked, timely action must be taken.

Review documents

Naturally, planning during a person's lifetime can minimise these risks. Taking time now to review pension documents, SMSF deeds, wills and powers of attorney to ensure these are appropriate is a good investment. This review normally should occur at least every three years and usually proves to be a worthwhile exercise to ensure everything is in order.

Binding death benefit nominations ('BDBN')

Most people consider that if they make a reversionary pension it is legally binding on the trustee. However, in most cases a reversionary pension is not legally binding as the trustee generally retains a discretion to revert or commute the pension (and say pay out a lump sum). Generally a reversionary nomination is a mere wish.

A valid BDBN will override a member's reversionary wish in their pension documents. This is because a BDBN is binding on a trustee whereas under most SMSF deeds, the trustee retains a discretion whether to continue or commute the pension.

One advantage of having a BDBN in place is that it can be used to direct the trustee to pay a pension to the member's chosen dependant. Therefore, the pension documentation will be overridden by the BDBN. This creates a situation where it is possible for a pension to be reversionary (due to the BDBN) even if there is no reversionary nomination in the pension documentation.

This highlights the need for consistency between the BDBN and pension documents. Ideally, every document should be carefully considered and consistent. Otherwise, costly legal challenges may arise.

Planning is the key

These days, there are a number of advantages to making pensions reversionary. There are also a number of methods to make a pension reversionary. In particular, care should be taken in selecting documentation from a quality supplier. Similarly, estate planning should be undertaken in conjunction with the establishment of the pension to ensure an integrated and consistent approach is implemented.

DBA Lawyers provides pension kits and tailored pensions as required, which include reversionary nominations. We also offer estate planning services, including tailored BDBNs, wills and succession planning to lock in reversionary nominations.

Insurance update

The ATO recently confirmed that if a deduction for life insurance has previously been claimed by a superannuation fund in respect of a member any lump sum paid to an adult independent child on that member's death may be partly subject to 31.5% tax (as an untaxed element calculated under s 307-290 of the ITAA 1997). Thus, a fund is forever 'tainted' if it deducts life insurance premiums for a member: see ATO ID 2010/76.

Advisers may need to undertake detailed past reviews of their SMSF clients to establish whether there is any such risk.

One strategy to minimise this risk is to transfer a member's benefit to another superannuation fund and ensure that no insurance deduction is ever claimed in the new fund. Alternatively, a member may wish to take out insurance though a public offer or industry fund, and keep the majority of their benefits in an 'untainted' SMSF.

For completeness, we note that the application of ATO ID 2010/76 will not impact a situation where a lump sum is paid to a tax dependant on the death of a member (eg, a spouse or child under 18 years or an adult child who is a financial dependant).

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