BDBNs v Auto-reversionary Pensions

There has been recent debate in SMSF circles regarding BDBNs and auto-reversionary pensions. This debate arises in the following situation.

A BDBN may prescribe that a member's benefits are to be paid to their legal personal representative (estate). Conversely, that member may also be receiving an auto-reversionary pension which specifies that the benefits should continue to be paid as a pension on the member's death to their spouse.

Upon the member's death, should the member's estate or spouse receive the benefit? Does the BDBN trump the auto-reversionary pension (or vice versa)?

Definitions

BDBN

A BDBN is a binding nomination that allows an SMSF member to direct the trustee to whom to pay their death benefit.

Because a BDBN is binding, the trustee must follow the member's instructions set out in the BDBN.

A properly drafted SMSF trust deed will allow for a BDBN to be executed by a member, which will bind the trustee upon the death of the member.

Auto-reversionary pension

An auto-reversionary pension refers to a pension that was set up with a specific provision. That provision stipulates that upon the death of the pensioner, the pension continues to be paid (ie 'reverts') to another person, who is typically a spouse.

Fettering trustees' discretion

Legal view

Generally, a trustee's discretion cannot be fettered (or restricted). That is, the trustee must exercise their discretionary powers and cannot restrain the powers they can exercise.

However, general law rules can be excluded by express provision in an SMSF's trust deed.

Therefore, potentially both BDBNs and auto-reversionary pensions are possible subject to the SMSF's trust deed.

Application of the law

Many modern SMSF deeds will have the following provisions:

- a provision allowing a trustee's discretion to be fettered by a BDBN; and
- a provision stipulating that although a member may request a pension, it is the trustee who resolves in its discretion to commence the pension and decide the terms.

Deeds typically oust the prohibition on fettering in respect of BDBNs. However, they fail to oust the prohibition in respect of auto-reversionary pensions. A validly executed BDBN however is typically far more likely to actually bind the trustee.

Accordingly, the BDBN would typically win in the event of conflict (subject to the fund's specific governing rules of course).

Specifically, a BDBN will prevail under a DBA Lawyers' SMSF deed.

Practical application

The members can avoid uncertainty by ensuring that their BDBN and their pension documentation are worded consistently.

It is good practice for advisers to periodically double check that the two do 'speak with each other' and take corrective action if they don't. Particularly, where an adviser is instructed to update a particular document (eg, BDBN or pension), this should be viewed as an opportunity to ensure that the two are consistent with each other and the deed.

Pensions — general planning and structuring

Given the ongoing changes over the past 10 years, there are many SMSF members who have more than one pension. They could have multiple pensions with different proportions of taxable and tax free components.

There are many planning opportunities that SMSF members can explore through pensions.

General tips and traps

Rolling pensions back

In order to prevent blending the proportions of various pensions' taxable and tax-free components, it

is important that SMSF members generally first exhaust their accumulation balance before rolling-back a pension. This allows the amount rolled back to be kept as a separate superannuation interest.

Documentation

Advisers must ensure that pension documents show all the rules and provisions of the pension. The documents should be in line with the SMSF deed and relevant legislative provisions.

Contribution caps

Often, after rolling-back pensions, a member who has reached their preservation age might like to top up their accumulation balance before starting a new pension. In this situation there is potential for contribution caps to be exceeded. This can result in adverse tax consequences and should be carefully managed.

Bankruptcy

Pension payments are treated as income and as such only receive partial protection from creditors. In comparison, an interest in a regulated superannuation fund or a lump sum paid after the date of bankruptcy is fully protected.

There is a risk that a trustee in bankruptcy might seek to step into a bankrupt member's shoes and request the SMSF trustee pay out their entire pension.

A well drafted SMSF deed can help minimise the risk associated with bankruptcy.

Proportioning rule strategies

The proportion of taxable and tax-free components for a pension are calculated when the pension is commenced as a fixed percentage. In a rising market, this is very attractive. Returns on the pension's investment will be allocated to the taxable and tax-free components in the same fixed proportion as when the pension started.

In accumulation mode however, the tax-free component remains nominally static, so when the accumulation balance increases, the tax-free component is diluted and the percentage is reduced.

Maximising the taxable component

Where an SMSF member has many pensions being paid to them, using up the pensions with higher taxable components to leave tax-free or low taxed pensions for the longer-term is an effective strategy.

If a member uses up their pensions with taxable components, and all that remains are pensions that have high tax-free components, the taxable component on death is reduced.

Members should consider the application of anti-avoidance provisions to this strategy, such as Part IVA of the ITAA 1936.

Choosing the appropriate strategy and getting the right advice

Each SMSF member will have different circumstances and objectives. Whilst pensions have potential benefits for all SMSF members, an appropriate strategy should be tailored to each individual member.

Particularly, advisers should ensure that pension documents are in line with other documentation such as a BDBN and wills. This allows pensions to bolster a member's overall succession planning.

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