

Controversial pension ruling: what it means for reversionary pensions

The ATO recently released a draft ruling regarding pensions. It is very controversial and has significant implications for SMSF succession planning. We consider a key aspect of the ruling: reversionary pensions.

What the draft ruling is about

Draft taxation ruling TR 2011/D3 considers when an income stream (eg, a pension) starts and stops. This is important for various reasons. One key reason is that to the extent SMSF assets are supporting pensions, SMSF income is tax exempt. Therefore, when a pension stops, the tax exemption stops.

The draft ruling states that a pension:

ceases as soon as the member in receipt of the [pension] dies, unless a dependent beneficiary of the deceased is automatically entitled under the superannuation fund's deed, or the rules of the [pension], to receive [a pension] on the death of the member.

The draft ruling further details the ATO's view that:

For a [pension] to be considered to have automatically transferred to a dependent beneficiary on the death of a member, the rules of the [pension] must specify this will occur. The rules must specify both the person to whom the benefit will become payable and that it will be paid in the form of a [pension]. The rules may also specify a class of person (for example, spouse) to whom the benefit will become payable. It is not sufficient that a [pension] becomes payable to a beneficiary of a deceased member only because of a discretion (or power) granted to the trustee by the trust deed or governing rules. The discretion (or power) may relate to determining either who will receive the deceased member's benefits, or the form in which the benefits will be payable.

In other words, the moment an SMSF pensioner dies, the SMSF loses some or all of its tax exemption. That is, unless the deceased's pension automatically continues to be paid upon the pensioner's death (ie, is 'auto-reversionary') the tax exemption ceases immediately upon death.

This is important for SMSF members who want their spouses to receive their benefits in the most tax effective manner.

Case study — practical implications

Consider the following situation. Sean and Katherine are a married couple. They are the only members and trustees of their SMSF. All of Sean's benefits are being used to pay him an account-based pension. All of Katherine's benefits are being used to pay her a transition to retirement income stream. The SMSF assets are fully utilised to pay the pensions. Accordingly, all income (including capital gains) generated by the SMSF is fully tax exempt. There is no provision in the governing rules of the SMSF that Sean's pension continue to be paid to Katherine upon his death. That is, the pension is not auto-reversionary.

Sean dies on 1 September 2011. The governing rules of the SMSF allow the trustee to resolve to pay Sean's death benefits to Katherine as a pension. However, Sean's death causes Katherine profound grief. It is not until a year later (1 September 2012) that she takes advice and arranges for a valid trustee resolution to pay Sean's death benefits to herself.

Under the draft ruling, the SMSF must pay tax on income (including capital gains) that relates to Sean's benefits derived between September 2011 and September 2012.

If however Katherine had been 'automatically entitled' to Sean's pension (ie, Sean's pension had been auto-reversionary), the SMSF would have retained the tax exemption for the entire time. This also would overcome the need upon Sean's death to make new documentation evidencing, for example, a new pension to Katherine.

How to make a beneficiary automatically entitled to a pension

The next question is how to ensure that someone is automatically entitled to a pension. Many simply make a 'pensioner request' and then trustee resolutions. Others make an agreement between the pensioner and the trustee. Each would specify that upon the pensioner's death, the trustee must continue to pay the pensioner's pension to a reversionary beneficiary/pensioner (aka a 'dependent beneficiary').

However neither of these methods by themselves are sufficient. This is because both constitute a fetter on a trustee's discretion. Finkelstein J summarised the position succinctly in *Fitzwood Pty Ltd* [2001] FCA 1628:

Speaking generally, a trustee is not entitled to fetter the exercise of discretionary power ... in advance ... If the trustee makes a resolution to that effect, it will be unenforceable, and if the trustee enters into an agreement to that effect, the agreement will not be enforced ...

Nevertheless, it is possible to validly fetter a trustee's discretion. This can occur where the governing rules of the SMSF allow it. See, for example, *Muir* [1966] 1 WLR 1269, 1283.

Accordingly, in order to ensure that someone is automatically entitled to the pension:

- firstly, the SMSF's specific governing rules must allow for such a fettering; and
- secondly, documentation must be created that ties in with the fettering power in the specific governing rules.

Subject to the specific governing rules, this documentation can be in the form of resolutions or an agreement. However, the most certain documentation is a deed. That being said, the drafting of a deed typically constitutes legal work and should only be handled by a lawyer (see, for example, *Legal Practice Board v Computer Accounting and Tax Pty Ltd* (2007) 213 FLR 212).

Ensuring pensions are reversionary

In light of TR 2011/D3, DBA Lawyers has launched a new 'Reversionary Nomination' service. For a fixed fee, DBA Lawyers will draft documentation to ensure that a pension is reversionary upon death and the tax exemption continues.

For more information, or to order, please visit www.dbalawyers.com.au/reversionary-pensions

Other considerations

The death of last spouse

Remember that adult independent children typically can not receive death benefits by way of pensions. Therefore, typically only spouses and children under age 25 can be made automatically entitled to pensions. This causes tax implications upon the death of the last spouse. Consider the following.

Jasmine and Aaron are in their late 60s. They have two adult children (aged 28 and 32). Jasmine and Aaron each receive a pension from their SMSF. The

pensions are automatically reversionary to each of them respectively upon death. Their SMSF has invested heavily in real estate and the real estate carries a huge unrealised capital gain.

Upon the death of the last of Jasmine and Aaron, the real estate must be either transferred out to their legal personal representative or a dependant. Either way, a CGT event will be triggered. When this occurs, under TR 2011/D3, the pension exemption will no longer apply. Accordingly, the SMSF could be liable for significant tax.

We note an anti-detriment deduction might be applicable here to reduce any tax payable (possibly to nil).

Non-tax issues

Naturally, tax should not be the driving consideration in succession planning. The more important question is who should receive wealth. It is better that the right person receive wealth and pay some tax than the wrong person receive wealth and pay no tax. Of course, as a secondary consideration, it is great if the right person can receive wealth in a tax effective manner. But, it is important not to lose sight of the 'forest for the trees'.

Therefore, before implementing documentation forcing a pension to be paid upon death to a spouse, the question should first be answered: is the spouse the right person to receive the wealth (especially if they 're-partner')? It could also be that the spouse has a gambling problem or a substance addiction. Therefore, it might be better to place the wealth in a testamentary trust where to the spouse is not a trustee. This allows for greater control and the prospect of also benefiting children and others too.

The Complete Guide to SMSFs and Planning for Loss of Capacity and Death

DBA Lawyers has launched this comprehensive and systematic 140+ page publication. It details the 11 practical steps you must take to properly and completely plan for an SMSF upon loss of capacity and death. It covers TR 2011/D3, anti-detriment deductions and much more.

To download a free sample extract, or for more information, please visit www.dbalawyers.com.au/complete-guide

For further Information please contact:

DBA LAWYERS PTY LTD (ACN 120 513 037) Level 1, 290 Coventry Street, South Melbourne Vic 3205

Ph 03 9092 9400 Fax 03 9092 9440 dba@dbalawyers.com.au www.dbalawyers.com.au

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