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SuperGuardian

Technical Bulletin: Paying pensions - the importance of planning ahead

Paying the minimum pension amount is a fundamental requirement to ensure an SMSF receives the appropriate tax concessions for meeting the pension standards. In the 2020/21 Financial Year the minimum pension has been reduced by 50% as a means to assist in the preservation of capital as a result of the COVID-19 pandemic and the economic impact it has had on superannuation assets, amongst other things. Whilst the measure is a welcome relief to some, who consider the minimum to be above their needs, others will continue to draw down benefits at prior year rates to meet their income needs or they will take over and above the minimum under the premise that you can't take it with you.

This bulletin takes a look at drawing benefits above the minimum pension, identifying amongst other things the value of multiple pension interests, contemplating funds with pension and accumulation interests, dealing with single pension accounts and the impact, if any, decisions will have on personal tax, fund tax, transfer balance caps and estate planning.

SMSF trends – a statistical approach

Each year the ATO release their 'Self managed super funds: A statistical overview' the most recent incorporating the 2017-18 year. Whilst the statistics are presented retrospectively, they can guide us in our prospective planning by identifying that on average many SMSF members, particularly those aged over 60, draw more than their minimum pension.

The 2017-18 statistics are valuable because they represent the first year that we moved into the transfer balance cap environment. What is noticeable from the snapshot below is that there was a significant increase in lump sum benefits, an equivalent decrease in pension payments and a decline in benefits paid from a transition to retirement income stream (TRIS).

On face value this is likely to be the case because funds were forced to roll portions of their benefits back to an accumulation interest due to the transfer balance cap meaning benefits were taken from an accumulation interest rather than a previous pension interest. Alternatively, it's in recognition of the potential strategic opportunities of taking a lump sum over a pension in certain circumstances.

Distribution of total SMSF benefit payments by benefit type

	2017-18	2016-17	2015-16	2014-15	2013-14
Lump sum benefit	29.7%	13.7%	11.5%	12.3%	12.6%
Income stream benefit	65.8%	78.0%	76.6%	75.3%	74.3%
Transition to retirement benefit	4.5%	8.4%	11.9%	12.4%	13.1%
Total	100%	100%	100%	100%	100%

Source: Table 10 - ATO SMSFs: A statistical overview 2017-18

Whilst the tables can be a little misleading, because they are either based on averages or the median value of account balances or benefit payments, what is overwhelmingly clear is that from a planning point of view most members are waiting until 60 before accessing their benefits as either a lump sum or pension. Less than 6% of members who access benefits via lump sum are accessing those benefits prior to age 60, excluding release authorities, and less than 2% of members who access their benefits as an income stream are under 60, excluding TRIS.

Comparatively over 88% of all pension recipients are over 60, which makes sense, and a further 9% are receiving a TRIS. Those stats are somewhat reflected in the following table that represents average account balance versus average benefit payment. Clearly those in the category of preservation age up to and including age 59 are averaging closer to the minimum pension requirement of 4%. Those that have hit age 60 are on average drawing in excess of the minimum.

Distribution of SMSF members receiving benefit payments by age, 2017-18

Age range	Members receiving benefit payments (%)	Average member benefit payment	Average member balance
< 55	2.1%	$26,254	$675,654
55- 59	4.1%	$46,355	$1,039,315
60-64	19.0%	$68,215	$1,100,624
65-69	29.1%	$74,870	$1,126,913
70-74	25.5%	$74,339	$1,161,484
>74	20.3%	$89,806	$1,192,211
Unknown	<0.1%	$101,799	$1,025,519
Total (all ages)	100%	$74,329	$1,130,960

Source: Table 10.1 – ATO SMSFs: A statistical overview 2017-18

If we assume that the majority of TRIS recipients are not TRIS in retirement phase but genuinely transitioning to retirement then we can also assume that there is little likelihood of them having unrestricted non-preserved benefits and as such the question of lump sum versus pension becomes a moot point, all withdrawals will be income stream benefits.

As a matter of course, that shouldn't discount the value of TRIS for future pension planning.

Why Transition to retirement is a friend not a foe

It has long been established, by Regulation and by regulatory confirmation, that once an income stream is commenced it will always remain a separate interest, unless the member elects to fully commute the pension or unwisely doesn't satisfy the minimum pension requirements deeming the pension to have ceased. This concept was made clear by the introduction of TRIS in accumulation and TRIS in retirement, and is supported by the pension standards that stipulate that the capital of a pension cannot be added to by way of contribution or rollover.

The result is that TRIS become the first significant single fund balance segregation strategy where it is conceivable for a member to start multiple interests comprising different tax components which may be of assistance to complex estate plans. Remember, a TRIS in accumulation is separate to an accumulation interest. All SMSF can only have one accumulation interest.

The purpose of multiple interests is going to be determined by the needs of the member, however, given the tax free and taxable components calculated at the commencement of an income stream apply to all income stream benefits and superannuation lump sums from that interest, if a member is looking to direct particular benefits to particular beneficiaries then the use of multiple interests may be an appropriate way to achieve this.

Example

Dave (59) has a $500,000 accumulation balance which is 100% taxable. He has the ability to contribute up to $300,000 as a non-concessional contribution using the current bring-forward provisions. As part of Dave's estate planning, he wants to split his superannuation benefits between his 2nd wife and his three (3) adult children from his first marriage.

Step 1 – Dave commences a pension for $500,000 (100% taxable)
Step 2 – Dave makes the contribution of $300,000
Step 3 – Dave commences a 2nd pension for $300,000 (100% tax free)

In this example, Dave makes the first pension reversionary to his wife, and ensures the second pension is subject to a Binding Death Benefit Nomination of a third to each of his children in accordance with the SMSF Trust Deed.

Whilst Dave may not want or necessarily need all of the income from the TRIS he can always recontribute part of the proceeds to an accumulation interest as a concessional contribution (mindful that he has used his non-concessional bring-forward), or make a spouse contribution. What Dave elects to do with his new interest is up to him but conceptually if he makes concessional contribution then upon retiring or attaining age 65 he is likely to be in a position where he can draw down those benefits and recontribute them as a non-concessional giving him maximum estate planning flexibility.

Taking all of this into consideration, it is clearly a necessary step in any pension planning to ensure the pros and cons of a TRIS are contemplated as there may be future benefits to splitting the tax components of a fund.

Taking lump sums versus additional pension payments

Recently we released a Fact Sheet 'Retirement Phase Lump Sum withdrawals' that dealt exclusively with the considerations for members who draw more than their annual minimum pension requirement.

If we assume that option one is just to treat all payments from a pension interest as income stream benefits, then there are two alternatives to consider and those alternatives may have alternatives if the member has multiple interests.

It should be stated that personal circumstances will dictate in every instance whether there is need, desire and/or scope to undertake an alternative to treating benefits as income stream benefits. Some of those circumstances are identified below.

Alternative One - Lump Sum Withdrawal from Retirement Phase pension account

According to the ATO statistical overview 33.6% of all SMSFs are fully in retirement phase. In this instance, members may choose to withdraw the excess over their minimum pension requirement as a partial commutation lump sum withdrawal from their retirement phase pension account(s). Any partial commutation will directly 'free-up' some of the member's Personal Transfer Balance Cap (PTBC) space. This is because a commutation creates a debit to the transfer balance account which can create additional room in the cap, unless the partial commutation is the result of an excess transfer balance assessment. Comparatively, regular pension payments have no impact on the PTBC.

Space in the PTBC can enable future contributions or rollovers from other funds (in accumulation phase) to be included in the tax-free pension environment. For a non-working member aged 67 or over who has all their benefits in the SMSF this may seem unnecessary or irrelevant but don't discount the opportunity that downsizer contributions may provide later in the member's life.

In addition to providing opportunity for future member contributions, it can also provide greater capacity to retain more benefits in the fund in the event of death. By freeing up PTBC space the transfer of a spouses benefit via a reversionary or discretionary pension may result in more of the spouse's benefit being able to be transferred, including insurance proceeds.

Alternative Two - Lump Sum Withdrawals from an Accumulation Phase interest

Whilst nowhere near as significant a number, 9.4% of SMSFs are partially in retirement phase, partially in accumulation phase. Given this also accounts for funds where one member is in retirement and others are in accumulation, it does represent a smaller portion of the SMSF community but an opportunity nonetheless. If available, perhaps because the member made contributions after commencing a pension or had a total superannuation balance greater than the transfer balance cap, the excess amount may be withdrawn from an accumulation interest. This can potentially provide tax benefits to the fund but also potentially to the estate if there are non-tax dependents.

Withdrawing from an accumulation interest does not reduce the PTBC as this relates only to amounts held in a retirement phase pension account. However, it does reduce the amount of the fund that is held in a taxable environment meaning more of the income, including capital gains, will be exempt from tax. This is because exempt current pension income of the fund is determined based on the proportion of the fund assets in retirement/pension phase versus the overall fund.

Making allowances for segregation strategies, which don't apply to funds where members are in receipt of a retirement phase pension and have a total superannuation balance in excess of $1.6million, an actuary will calculate these proportions to determine the exempt income percentage for tax purposes. Drawing down from the accumulation portion of the fund will generally increase the exempt percentage for the year. The higher the percentage of assets supporting the pension, the higher the exempt current pension income deduction and this can result in lower income tax for the SMSF. The reverse can be said of partial commutations, they will reduce the pension assets, as will excess pension payments, in the event the member determines to take the proceeds from a pension interest.

Strategy Consideration – timing and source
The actuarial calculation uses daily weighted average calculations meaning the size and timing of excess withdrawals during the year are factored in. On this basis, a lump sum taken earlier in the financial year from an accumulation interest will have a greater positive impact on the actuarial percentage than it would if taken later in the year, as more of the fund would be in retirement phase over a longer period. As stated above, a partial commutation would be more beneficial if taken later in the year as it would not erode the pension balance as an overall percentage.

Another impact item since 1 July 2017 is that partial commutations do not count towards the minimum pension, so any commutation must be taken in contemplation of ensuring sufficient cash is retained to pay the minimum.

Strategy Consideration – multiple interests and market conditions
By identifying that lump sums are an alternative to paying additional pensions we are also identifying that there is no "one size fits all" approach. If we take Dave's example and assume Dave has subsequently retired with a 100% taxable pension and a 100% tax-free pension based on components, then which pension will Dave take the additional lump sum from? The answer will of course be "it depends" but Dave will need to give consideration to what impact any ad hoc payments may have on his estate planning.

Further, it shouldn't just be accepted that if a member has pension and accumulation interests that the lump sum will be taken from the accumulation interest. A lump sum from an accumulation interest is proportioned based on the components immediately before the lump sum is taken whereas from a pension the proportions are set at commencement. In an accumulation interest growth is attributable to the taxable component and similarly losses are as well. In a depressed market a lump sum from accumulation may have a greater impact on an individual's tax free component so it may be more appropriate to draw down from a higher taxable component pension.

If any amount is to be treated as a lump sum rather than a pension payment, then the trustees/members need to be aware than an election must be made in advance. This is important as transactions cannot be backdated and any commutation from a retirement phase pension must be reported via the Transfer Balance Account Report with the ATO, in some circumstances that report may be required 28 days following the month the payment is made. Payments need to be allocated as intended from the date of the withdrawal and decisions can't be made retrospectively. In advance may also incorporate standing instructions at pension commencement i.e. "all withdrawals in excess of the minimum are to be treated as ……".

It is also important to consider how the allocation of withdrawals may affect any Centrelink entitlements, so we recommend checking with them in relation to the impact based on personal circumstances.

As for which interest to take a benefit from, there is clearly advantages to taking benefits from those interests with the highest taxable component, if the member is 60 or over, however, consideration must also be given to estate planning to ensure that any original estate plan is not compromised by the draw down.

Withholding tax obligations and where they might apply

Withholding tax is only a consideration when benefits are taken prior to age 60, a matter that it also relevant if a member passes away prior to age 60 and their spouse is also under 60. Given that preservation age is now 58 the window for needing to withhold tax is narrowing but it is still a consideration.

On face value if a member is under the age of 60 and receiving a retirement phase pension then the natural thought process is to treat excess withdrawals as a lump sum because the individual is entitled to the superannuation low rate cap on lump sum withdrawals, meaning they don't pay tax on any taxable component up to the cap, currently $215,000 in the 2020/21 financial year.

This thought process is certainly appropriate for members with larger balances required to take greater minimums who want to draw additional benefits. However, the additional cost that may be associated with taking a lump sum when factored in with the low income tax offset and low and middle income tax offset (available up to and including the 2021/22 financial year) mean that for those with lower incomes and smaller minimum pensions, the tax benefit may be negligible.

Consideration summary

Account based pensions are by their nature a soft-compulsion withdrawal strategy meaning there is a tax incentive for people to use them as the payment vehicle of choice but it is not compulsory. So whilst there may be a significant tax benefit to having and maintaining an account based pension there are many considerations that go along withobtaining the tax concessions.

Centrelink/DVA – drawing down lump sums from a post 1 January 2015 account based pensions will have little to no effect of a member's age pension entitlement given deeming provisions now exist and the rates are so low. However, for anyone with a pre 1 January 2015 account based pension that is grandfathered, lump sum withdrawals will reduce the Centrelink return of capital calculation potentially resulting in a higher assessable income. It's a catch 22 because not taking a lump sum will also result in a higher assessable income as actual income taken is reported to Centrelink/DVA.

Withholding tax – the superannuation low rate threshold is quite an incentive to take lump sums rather than pensions prior to age 60 but when considered as part of a pension strategy may result in negligible tax benefit when measured against potential increased costs.

Process – whether benefits are taken as a lump sum or as a pension may be a moot point if the trustees don't act. It is well established within the industry that lump sum withdrawals cannot be elected retrospectively and so it is incumbent on trustees to be proactive and nominate in advance, perhaps even at commencement of the pension as to how excessive pension payments are going to be treated. It's also important to determine whether additional fees will apply given the potential for additional paperwork to accommodate any lump sums and additional reporting under the transfer balance cap regime.

Overall when undertaking pension planning, it should always be in advance and should also be built for purpose. A client with no transfer balance cap issues, either themselves or their spouse, no insurance, no likelihood of using the downsizer contribution and a very simple estate plan probably doesn't need to bother with anything beyond paying regular pension payments.

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