EDUCATION

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Bear market effect
on super income streams

The recent capital market meltdown has had a significant impact on almost everyone holding market investments. SuperGuardian's Brendan Daw examines some of the effects on self-funded retirees drawing a super income stream and ideas that may help to minimise the impact. The article is primarily focused on account-based pensions in self-managed super funds (SMSF), however, it may have wider application to retail and industry funds.

> "The Australian Taxation Office may look unfavourably on accounting for diminution of assets if it believes the primary purpose was to minimise pension levels."

Many superannuants rely on a regular pension from their superannuation to meet daily living expenses. With some good financial planning, the regular withdrawal provides a comfortable income to meet daily living expenses for the remaining life of the member.

Often pension accounts are partially backed by non-cash market investments. A common strategy has been to set aside several months of pension payments and hold listed investments that can be sold and capital gains realised (tax free) in a growing market at the time that cash was needed to fund pension payments.

In today's market, this may be a deficient strategy due to insufficient cash being available to meet pension requirements and ride out a prolonged bear market. This may result in the need to sell investments to cover pension amounts when prices are low.

Continuing to withdraw the same pension levels, especially if the market conditions remain deflated for an extended period, can have a compounding effect over time as the capital base is being eroded. The pension balance may run out prior to the death of the member.

Pension recipients in these circumstances should consult their financial advisers and consider:

- **Reviewing the investment strategy:** Consider the current risk profile and investment mix in this market and alternative investments that might provide the necessary cash-flow requirements. Take a long-term view and provide adequate cash reserves to cover pension requirements.
- **Reducing the pension income stream:** Consider revising living habits and reducing pension amounts. This may be a temporary strategy depending on how long the market remains in decline.
- **Meeting the minimum pension level:** Reducing the pension withdrawals could mean the minimum pension level is not met. In such circumstances, consider stopping the existing pension and restarting from a lower base. There may be a cost in doing this.
- **Accessing or increasing Centrelink benefits:** The many aspects of government pensions are too broad to cover in this article. The basic aged pension is available for men (aged 65 or over) and women (63-65, depending on birth date). The recipient must meet residency requirements and the rate of payment is based on the lower of the income and assets tests.

The asset test upper thresholds are currently:

- Singles $550,500 ($675,000 non-home owner),
- Couples $873,500 ($998,000 non-home owner), and
- Couples separated due to illness $1.001 million ($1.125 million non-home owner).

Assets include money held in superannuation once a person reaches pension age. Term allocated pensions started prior to 20 September 2007 attract a 50 per cent concession.

As financial markets have declined, an individual's combined assets, including superannuation savings, may now be less than the asset threshold. If the asset test is close to being reached, consider withdrawing a tax-free lump sum and using the cash for an exempt asset such as home improvement or holiday.

The income test upper thresholds per fortnight are currently:

- Single $1557.75,
- Couple (combined income) $2602, and
- Couples separated due to illness (combined income) $3079.50 plus $24.60 per child.

A portion of the super pension is combined with other personal income when determining eligibility under the income test.

With a decline in value of the underlying member's account, reassessing the pension amounts during the financial year could result in a reduced income stream from super and increase the government age pension. This can be done by stopping the pension during the year and commencing a new pension based on a lower member balance. This will only provide a short-term benefit, as the pension level will be reassessed at the start of each financial year.

WEALTHY INDIVIDUALS – MINIMISING THE SUPER INCOME STREAM

Wealthy individuals may have alternative sources of income, such that they do not need to rely on a super pension for their current daily living. The strategy may be to retain as much money in the tax-effective super environment and minimise any pension withdrawals.

Under the existing account-based pension rules (*Superannuation Industry (Supervision) (SIS) Regulations* schedule 7), the member must draw a minimum income stream based on a percentage of their member balance at the start of each financial

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year, or if it commenced during the financial year, the balance on commencement.

The member balance may be much less now than it was at the start of the financial year, which means the minimum pension level is more than what it would be if it were calculated now. These are some factors to consider:

- **Timing of withdrawal:** The pension can be withdrawn at any time during the financial year. This means the member can choose a rational time to sell investments to pay the minimum pension amount.
- **Stopping the pension:** The member can elect to stop an account-based pension at any time. This can be done simply by requesting the trustee to stop the pension, and then the trustees formally agreeing (in writing) to stop the pension. Members should note:
  - The pro-rata minimum pension must be withdrawn prior to stopping the pension.
  - The income and capital gains become taxable from that point onwards.
  - Capital losses cannot be offset against income and remain until they can be offset against future capital gains.
  - Any future gains made while in accumulation phase will result in a lower tax-free percentage when a new pension commences.
- **Stopping and restarting the pension:** The members may request the trustees to stop and restart the pension. Provided it is allowed within the trust deed of the fund, it is a legitimate strategy. This may be done through a resolution by the trustees acknowledging the member's request and declaring that under current market conditions it is prudent to stop and restart the pension in order to preserve the member balance to meet the future needs of the member. This strategy can be run effectively within an SMSF environment, however, fees may apply. Members should ensure pro-rata minimum pension amounts have been taken prior to stopping and restarting the pension.
- **Timing effect on the tax-free percentage:** Superannuants who have held back starting a pension, or those that stopped a pension earlier in the year and are now looking to restart it, may find they get a better tax-free percentage. While in accumulation phase, the tax-free portion of the member balance doesn't change even though the member balance may be decreasing due to the market downturn. On commencement of a pension, the fixed dollar value of the tax-free portion divided by the lower member balance results in a higher tax-free percentage.

For example, John's member balance on 1 July was $1 million, with $500,000 tax free. If the pension commenced on 1 July, the tax-free percentage is 50 per cent.

However, if John's pension commenced in December, the market value of assets has decreased to $750,000, the tax-free percentage is now 66 per cent.

The tax-free percentage is set for the life of the pension from the day the pension commences. This may benefit the pension recipient up until the age of 60 (when it becomes tax free) and may also reduce any tax payable by the beneficiary on death of the member.

- **Measuring the pension value – diminution of assets:** Australian accounting standards require superannuation funds to measure assets at their net market value as at the reporting date. The standards state a superannuation entity should not adjust the value of assets to reflect events that occurred after the reporting date – such as a reduction in market value that occurred between 30 June and the date the year-end accounts are prepared.

An SMSF is not strictly a reporting entity and therefore does not have to comply with the accounting standards, and it is not specifically prohibited in the *SIS Regulations*.

If the SMSF recognises the diminution in assets, the member account balance as at 30 June will be reduced. As this balance is used to calculate the current year minimum pension amount, it can result in a lower pension minimum for the current year.

However, the Australian Taxation Office (ATO) may look unfavourably on accounting for diminution of assets if it believes the primary purpose was to minimise pension levels. Trustees electing to do so should be consistent and in future years recognise increases in market value post balance date, which may negate the benefit over the long term.

- **Making in-specie pension payments:** In-specie payments are the transfer of assets in lieu of cash payments. The trustees of an SMSF may wish to, for example, make a pension payment by transferring an asset the member would like to hold personally, such as artwork or real estate, rather than selling the asset at deflated prices and losing control over it.

The ATO does not endorse in-specie pension payments (SMSFR 2008/2). However, there is no specific prohibition in superannuation or tax legislation. Some professionals believe it can be done if allowed in the trust deed. If considering this, seek opinion from the fund auditors and ensure an arms-length market value is used.

In conclusion, there is no magic solution to the financial crisis. This is a time when the financial adviser should actively assist clients in reviewing the pension strategy. «

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