

Tax treatment of pension assets upon death

The Australian Tax Office (ATO) has issued a new draft ruling (TR 20011/D3) to clarify when a superannuation pension account commences and ceases. The ruling is also relevant in determining the tax treatment of superannuation pension assets following the death of a member.

The key components and issues outlined in the ruling are:

Requirements of a pension

A pension requires a series of periodic payments that relate to each other and:

- a payment should occur at least annually; and
- a minimum pension amount must be paid to the member each year.

When a pension commences

According to the ATO ruling, a pension commences on the first day of the period to which the first payment of the pension relates. This is determined by the terms of the pension, the fund's trust deed, and the relevant legislation of the SISR 1994.

The commencement day may be before the first payment, but cannot be prior to the day on which:

- the pensioner and the trustee agree on the terms and conditions of the pension; or
- a trigger point occurs resulting in the member becoming eligible under the terms of the deed.

It is essential that there are specific terms and conditions for the pension and evidence is required to support this. Trustees must ensure the appropriate documents are in place.

Finally, all rollovers and contributions must be received before the pension starts.

When a pension ceases

A pension ceases when there is no longer a member or dependent beneficiary who is automatically entitled to

receive a pension from the member's pension account. Common circumstances where a pension ceases are:

- failure to comply with the pension requirements of SISR 1994 (e.g. failure to pay minimum pension for the period);
- exhaustion of the capital supporting the pension;
- commutation of the pension; and
- death of the member in receipt of the pension, unless a reversionary pension is in place.

Dependent beneficiary

It is important to remember that a death benefit can only be paid as a pension if the recipient is:

- a spouse, interdependent or ordinary dependant; or
- a child who is:
 - under age 18; or
 - under age 25 and financially dependant on the deceased; or
 - age 18 or more but suffering from a qualifying disability.

The draft ruling confirms that:

- if no dependent beneficiary is automatically entitled to receive an income stream upon the death of the member, a pension ceases on the date of death of the member and converts to accumulation phase;
- if the fund trustee has any discretion as to who receives the death benefit, or the form of the benefit, the automatic qualification will not be met and the member balance will revert to accumulation on the date of death. If trustees exercise their discretion to pay a benefit as a pension and the benefit is not paid for some time, the member balance is considered to be in accumulation until the commencement of the death benefit pension; and
- if the minimum pension requirement has not been met prior to the date of death, the pension ceases from the beginning of the income year and any benefits paid from the account would be classified as lump sums.

Accordingly, where the trustee has discretion, the implications of these rules are:

- where the pension benefits are paid out to a spouse, additional taxes will be payable. If the assets in the pension account have been held for many years, the potential tax liability could be significant and include:
 - the sale of assets to pay death benefits will be subject to 10% capital gains tax; and
 - any income and earnings received by the fund from the date of death will be subject to 15% income tax. In addition, this outcome will also result if the benefit is paid to a non-dependant child or dependant child.
- if the minimum pension amount was not paid prior to the date of death, the member will lose out on the 0% tax concessions that would normally apply to their pension account for the full year; and
- upon withdrawal of the benefits from the fund, non-dependant beneficiaries will pay 16.5% tax on the taxable component of the member balance.

Action required

Members will need to ensure they:

- plan their pension payments for the year;
- have either a reversionary pension or a valid binding death nomination in place; and
- review the trust deed of the fund to ensure a reversionary pension can be paid.

Caution is required

Any change to an existing pension will result in the commencement of a new pension, therefore be mindful that simply adding a reversionary to a pension may not be appropriate:

- as it may impact Term Allocation Pensions and their Centrelink exemption (if applicable);
- if the member has any benefits in accumulation phase, they must be added to the new pension; and

- as the ruling is proposed to be effective from 1 July 2007, benefits previously paid may be effected and additional tax may be payable by the remaining members.

Binding death nomination

When completing a binding death nomination, the member should ensure the notice:

- nominates eligible nominees to who the benefits are to be paid; eligible persons include only a legal representative or dependant of the member;
- clearly confirms the allocation of the benefits amongst the nominees;
- is in writing and signed and dated by the member in the presence of two witnesses, being persons who have turned 18 and are not mentioned within the notice; and
- contains a declaration signed and dated by the witnesses stating that the notice was signed by the member in their presence.

Due to the potential tax liability it is essential to obtain the correct advice when establishing a pension and structuring the payment of death benefits to beneficiaries.

If you require any assistance in this area, please contact your PKF representative and we can assist you with determining the right solutions for your circumstances.

Once the final ruling is issued it is proposed to apply from 1 July 2007.

Should you require assistance or additional information, please contact your PKF Tax adviser or:

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