Remember Those Minimum Pension Payments

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Failure to make minimum pension payments into a self-managed superannuation fund (SMSF) places valuable tax concessions at risk.

Why is this the case? Quite simply, superannuation legislation requires pension-paying SMSFs to meet minimum pension requirements and to pay this amount in the year it is due.

Payment does not mean making an entry in accounts and treating the pensioner as a creditor; it means paying the actual pension.

From the feedback I am receiving and from my observations, there are a good many SMSFs who are making part or full pension payment after the end of the financial year. I don’t believe this is being done intentionally but rather that trustees are unaware they have failed to make the necessary minimum payments and only discover this when their financial year-end accounts are being prepared.

Unfortunately this is too late in the day to take corrective action.

Failure to pay the minimum pension in any given year may mean tax exemption on income earned by the fund will be deemed ineligible. Given that tax rates for non-complying funds will increase from zero to 15 per cent, the impact could be an unnecessarily large tax bill.

Under superannuation legislation and regulations, once a fund member reaches preservation age (currently 55) and begins drawing a superannuation income stream pension (which commonly takes the form of an account based pension*) it is crucial that the minimum pension be paid each year.

The minimum pension starts at 4 per cent of a member’s account balance at the start of the financial year for those aged 55–64 years. (This was reduced to 2 per cent for both the 2009/10 financial year and the previous financial year.) If the pension commences during the course of the financial year, the account balance at the start date is used and a pro-rata payment has to be made.

The minimum percentage increases after 64. (See Table 1 for full details on percentage minimum pension payments according to age.)
The minimum pension payable is calculated on a pro-rata basis, based on the number of days in the first financial year if the start date is not 1 July.

The example below explains how the process works. In a fund where both members are retired and in their late 60s and the fund has a balance of $1 million at the start of the financial year, the minimum pension that must be paid in the 2009/10 year is $25,000 (Note: 2.5 per cent of $1 million as pension percentages have been halved for the 2009/10 financial year).

Should the fund have a taxable income from investments of $50,000 for the year, provided the pension paid to the members is at least $25,000, there will be no tax on the fund’s income.

However, if the fund pays a total of $20,000 to its members, the fund could be deemed not to have met the minimum pension and as a result the trustees may be liable for a tax bill of $7,500 – 15 per cent of $50,000.

The Australian Tax Office understands that there can be factors beyond trustee or members’ control preventing them from meeting requirements. For example, SMSFs may not have been able to liquidate fund assets as a result of recent global economic conditions, which saw withdrawals temporarily prohibited, preventing pensions being paid.

To assist trustees during these difficult times, the Government elected to reduce the minimum percentage pension payable as a short-term measure. (There has been no indication this reduction will continue beyond 30 June.)

However, it is important trustees realise the tax office does not treat offences which are intentional or reckless, lightly. Pleading ignorance of superannuation legislation and regulations, and forgetting to pay a pension would not fall into the category of ‘factors beyond the trustees’ control’.

WHAT SHOULD BE DONE?
As with most problems, prevention is better than cure.

1. Familiarisation with duties and obligations
Trustees and members need to properly familiarise themselves with their duties and obligations regarding superannuation income streams. This should be done at the time members’ pensions commence.

2. Keep matters well documented
Once a pension/s commence, trustees and members should document issues such as such as
- Pension terms and conditions,
- Taxable and tax free components of the pension account,
- Preserved and non preserved amounts if a transition pension is to be paid, and
- What is to happen when the pensioner dies – who is the beneficiary and is it to be paid as a pension or a lump sum?

Remember this documentation must be longer and more detailed than just one short paragraph in trustee minutes. These documents form part of the rules under which the fund operates.

Unfortunately, we are still seeing examples of SMSFs not properly recording pensions. This could result in confusion after the pensioner’s death about who will receive the death benefit and how it will be taxed.

Should SMSF members/trustees find they are unable to prepare the appropriate paperwork, they should seek assistance from their fund’s advisors.

3. Use correct balances
For pensioners with account-based pensions, balances as at 30 June should be used to calculate minimum pension requirements for the following year. If the pension commences during the year, an interim set of accounts is required with the pension being paid that year, based on these accounts.

4. Early preparation
Trustees of pension paying SMSFs should aim to have their financial statements and accounts prepared as soon as possible after the financial year. A side benefit of this is that it enables the annual return to be lodged with the ATO early, ensuring any tax refunds are received without delay. Assuming all members have retired and are in receipt of pensions, the fund will not be taxed on earnings and instead will be entitled to a tax refund during the year, such as franking credits attached to dividends.

Early preparation of the fund’s accounts also means SMSF pensioners receiving periodic pension payments will have adequate time to adjust these payments to ensure the minimum pension is paid during the year.

Table 1. Minimum Pension Payable

<table>
<thead>
<tr>
<th>Age</th>
<th>Percentage of account balance*</th>
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<tbody>
<tr>
<td>55 – 64</td>
<td>4%</td>
</tr>
<tr>
<td>65 – 74</td>
<td>5%</td>
</tr>
<tr>
<td>75 – 79</td>
<td>6%</td>
</tr>
<tr>
<td>80 – 84</td>
<td>7%</td>
</tr>
<tr>
<td>85 – 89</td>
<td>9%</td>
</tr>
<tr>
<td>90 – 94</td>
<td>11%</td>
</tr>
<tr>
<td>95 or more</td>
<td>14%</td>
</tr>
</tbody>
</table>

* Account balance and age at 1 July each year. If the pension starts at a date other than 1 July, these are calculated at the pension start date for the first financial year.
5. Commuting pensions if required
If trustees do not believe they can meet the minimum pension requirements and to avoid breaching the pension rules, consideration should be given to commuting (stopping) pensions and getting them reset at a level that is achievable.

Again early action is desirable. Action means that at least some of the fund’s income will be exempt from income tax. For the period from 1 July to the date of commutation, the pension is payable on the full account balance. Because it is only being paid for part of the year, the minimum pension is calculated on a pro-rata basis.

The pension payable from the date the new pension commences to the end of the financial year is also calculated pro-rata, based on the new pension account balance.

6. Reset as two separate accounts
Having commuted the pension account and recommenced a new pension with a smaller balance, the remainder of the member’s entitlements will be in an accumulation account.

Effectively the person becomes two members of the same SMSF. The minimum pension payable is based on the new pension account. The fund will be subject to tax on the earnings attributed to the accumulation account.

Because members will now have two accounts, accumulation and pension, an actuarial certificate will be required at 30 June in order to determine the percentage of the fund’s income that is tax exempt.

Trustees deciding to use the commute and restart option need to be aware of pension standards and documentation requirements.

7. Segregate assets
The alternative to obtaining an annual actuarial certificate is to segregate assets between the two accounts – a concept SMSF trustees may not be able to put into practice themselves. Segregation means operating the super fund as two funds.

Each member account would have its own bank account and investments. Income from these investments would go into the appropriate bank account and expenses paid from the appropriate account. This may require splitting of some bills such as the audit fee.

8. Track pension payments
Trustees paying income streams must have a mechanism for tracking pension payments or flagging when they should be made. This is especially relevant to members intending to withdraw an annual lump sum in June to satisfy the minimum requirements.

In circumstances such as this, I would suggest something as simple as making a diary note for early June. Apart from allowing time to make the payment, this should provide sufficient time to cash in or sell one or more investments in order to pay the required pension.

9. Demonstrate liquidity
Under superannuation legislation, a fund’s investment strategy must demonstrate liquidity and the ability to pay expenses or make benefit payments. Trustees operating in accordance with their investment strategy could be expected to be in a position to make pension payments without delay.

The ATO views forgetfulness dimly. By simply stating that you, the trustee and member, forgot to make the required payment in June but drew down the amount in early July – claiming a timing issue – is just not good enough and it is doubtful if it would be seen as a genuine excuse.

FACTORS BEYOND TRUSTEE CONTROL
What constitute factors beyond a trustees’ control? Here are several examples:

Example 1
Two people have their own SMSF. They would typically be husband and wife or a couple in a de-facto relationship. One of the members falls seriously ill towards the end of the financial year and the other partner’s attention is focussed on getting them well, rather than on the fund.

This could result in matters being delayed or forgotten, something the ATO fully understands.

Example 2
The SMSF has non-liquid assets in its investments such as property or shares in unlisted companies. By way of example, the fund as units in a mortgage trust and it is the intention of trustees to redeem some of these units in order to make the required minimum pension payment. Prior to redemption, the fund manager announces a freeze on withdrawals.

As a result, trustees are unable to access cash, other than a small amount, so are not in a position to make pension payments in the short term.

Other types of pensions?
Apart from account-based pensions, other superannuation pensions are as follows:

Allocated pensions – this was the most common type of pension being paid in the private sector prior to the Liberal Government’s superannuation changes that took effect from 1 July 2007. Almost all of these pensions have converted to other pensions. For the few with this type of pension, the minimum percentage for each age per the table provided by the government has been halved for the current financial year.

Term allocated pensions – these operate with a specific percentage for each age for each pension based on the initial term of the pension. For the 2009/10 year, a person in receipt of a term allocated pension can elect to have this percentage reduced by 50 per cent.

Defined benefit pensions – recipients of this type of pension are unable to change the pension payment required so must ensure there is sufficient liquidity within the fund.