Dethroning defined benefit pensions

Once the crown of the pension throne, defined benefit schemes face a very uncertain future.

Summary: The Federal Government's new $1.6 million transfer balance cap will ultimately kill defined benefit pension schemes. The Government will value these pensions 'lump sum equivalent' at $1.6m and tax income in excess of $100,000 per annum.

Key take-out: Defined benefit fund members expecting a retirement pension greater than $100,000 per annum will be hit hard under new super laws. Investors should rethink the urban myth of never partially or entirely 'cashing in' a defined benefit pension, with examples shown below.

Key beneficiaries: Superannuants, retirees. **Category:** Superannuation, retirement.

The long-time star of the pension series – the defined benefit fund – may have effectively been killed off by the Federal Government.

Under the new $1.6 million transfer balance cap rules taking effect from July 1, 2017, pension income from defined benefit funds will be valued using a multiple of 16.

Those expecting a retirement pension greater than $100,000 per annum will be hit hard under these new laws, including senior public servants and academics. The Government will value their pension 'lump sum equivalent' at $1.6m and tax their income exceeding $100,000 pa.

Defined benefit scheme members who have not have cashed out at least part of their pension (to free up their options) are locked in, as the following case study demonstrates:

- Sue is 67 during the 2017-18 financial year and receives a defined benefit life expectancy pension which commenced before July 1, 2017.
- Her pension qualifies as a 'capped defined benefit income stream' and is comprised of a 'tax-free' component and a 'taxed' element.

- For the 2016-17 financial year, Sue's pension is non-assessable, non-exempt income.
- In 2017-18, however, as Sue receives $150,000 from her pension, the sum of the benefits comprising the tax-free component and taxed element will exceed her $100,000 'defined benefit income cap'.
- Sue must therefore, include in her 2017-18 financial year assessable income, 50 per cent ($25,000) of the defined benefit income that exceeds her defined benefit income cap.
- She is not entitled to a tax offset in relation to this income. Sue needs to declare this income by lodging an individual income tax return, and as a result, may have an income tax liability.
- Conversely, had Sue's benefit originated from a 100 per cent 'untaxed' pension fund (as is the case with Super SA pensions) the 10 per cent untaxed defined benefit pension offset would be capped at a maximum of $10,000.

In Sue's scenario above, assuming her $150,000 pension was all 'untaxed component', the loss of the tax offset over $10,000 will result in her pension income being fully taxable and the income above $100,000 pa taxed at the full 39 per cent marginal tax rate. That equates to approximately $36,131 in net tax on the $150,000 untaxed pension income, for a still comfortable net result of around $113,869.

Reminder of the golden investing rule

The new transfer balance cap rules are the final nail in the coffin for defined benefit pension schemes, most of which are now closed to new members and have been for several years. There is perhaps no future for defined benefit income streams either, which have also been declining over time. These overly generous schemes have caused funding problems and trustees in conscience will struggle to keep accepting new members.

Furthermore, the defined benefit income cap may force members of these schemes to rethink the urban myth that a defined benefit pension should never be 'cashed in' partially or entirely.

Not cashing in part of a defined benefit pension breaches a core tenant of investing: always diversify. Retaining 100 per cent of a defined benefit pension is equal to having all your eggs in one basket.

Opportunities outside the 'defined' area

The $1.6m super cap will affect a lot more people than initially understood. However, there are still significant wealth-generating opportunities left to those in the current system not locked into a defined benefit fund.

As the $1.6m cap applies to each partner in a relationship, the opportunity here is creating a $3.2m super fund. If one partner has over $1.6m in accumulated benefits and the other has less, transferring up to the elevated cap should be the first item on the checklist. The return on the family's $3.2m could approximate a tax-free $240,000 pa, without eating into capital.

Bear in mind as well, any excess over the $1.6m cap can still be rolled back into superannuation accumulation phase with investment income attracting a 'concessionally' taxed rate of 15 per cent pa.

With effective planning, however, this concessional tax rate can be further minimised. Consider this example, and compare it to our friend Sue above:

- A single person over 60 at July 1, 2017 with $2m in an account-based pension withdraws $400,000 (the excess over the $1.6m cap) to achieve taxable income of $30,000 pa (assuming a notional investment income of 7.5 per cent pa on $400,000).
- The retained $1.6m account-based pension income remains tax exempt and the (non-super) investment income of $30,000 is now the only taxable income.
- As the level of taxable income is below the current single person senior Australian pensioner tax offset threshold of $32,279 pa, there is no personal tax liability and no tax return to lodge, unlike in Sue's case. With annual income of around $150,000 post-July 1, this is clearly an excellent outcome.
- However, perhaps the simplest capital gains tax-free option to deal with retirement funds over $1.6m is to upgrade the family home. Australian homes have historically increased in value at a generous rate of 7.5 per cent pa, having the potential to increase the value of your estate and keep the tax-man from the door.
- Another strategy might be to gift the excess as an early inheritance – but be aware of the complex Centrelink rules around gifts over $10,000.

The new super rules are very complex and require considerable administration. Successive governments have made it almost impossible to successfully navigate the super/tax/Centrelink interface without the help of a qualified financial planner.

Theo Marinis