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REVERSIONARY NOMINATIONS V BINDING DEATH NOMINATIONS

With the introduction of the super reforms on 1 July 2017, it is time to revisit the key differences and considerations when deciding whether to have an automatically reversionary nomination, or a binding / non-lapsing death benefit nomination for account-based income streams.

Yvonne Chu

Death benefit nomination options

Under superannuation legislation, super fund members commencing an account-based pension have the following options (subject to the fund's governing rules) for death benefit nominations:

- Automatic reversion nomination
- Binding death benefit nomination
- Preferred / no death benefit nomination

Automatic reversion nomination

The SIS Regulations specifically allow account-based pensions that are payable for the life of both a primary and reversionary beneficiary.

Members can therefore commence an account-based pension that automatically reverts to a reversionary beneficiary upon the pensioner's death.

In this case, the account-based income stream reverts as the governing rules expressly provide for reversion, as opposed to the superannuation provider exercising a power or discretion to pay an account-based pension to the beneficiary.

Binding death benefit nomination

The SIS Act and Regulations allow members to make the following nominations that (if valid) are binding on the trustee:

- Binding death benefit nominations, which must:•
  - be renewed every 3 years
  - be witnessed by two adults who are not nominated beneficiaries
  - must specify an ascertainable proportion to be paid to each beneficiary
- Non-lapsing death benefit nominations, which do not lapse but require the consent of the super fund trustee

For simplicity, throughout this article we will refer to binding death benefit nominations and non-lapsing death benefit nominations collectively as binding death benefit nominations.

The quote

Where the reversionary spouse is unlikely to meet one of the specified conditions of release, clients should consider not setting up a reversionary TTR income stream.

SMSF binding death benefit nominations

Large super funds generally must not permit a discretion under their governing rules that is exercisable by a person other than the super fund trustee. One exception is binding death benefit nominations made in accordance with SIS reg 6.17A.

In contrast SMSF members are also trustees of the fund and so SMSFs are subject to slightly different rules than large super funds regarding making binding death nominations. The rules governing how death benefit nominations can be made and apply are governed by the SMSF's trust deed, rather than SIS reg 6.17A.

This may, for example, allow SMSFs to make binding death benefit nominations that don't lapse or don't require specific witnessing.

It is very important for SMSF members to ensure their binding death nominations are valid by meeting all requirements set out in the trust deed.

Preferred / no death benefit nomination?

Where no automatically reversionary of binding death benefit nomination is made, members may make:

- a preferred nomination of beneficiaries, or
- no death benefit nomination.

Where a preferred nomination is made, trustees must consider the member's request, and potentially other available information, but are not bound to follow the nomination.

Where no nomination is made, the fund's default provisions apply, which could (depending on the fund's trust deed) require automatic payment to the estate, or give the trustee discretion regarding the death benefit payment.

Where a non-reversionary pension is chosen by a pensioner, it is often preferable to have a binding death nomination in place (and regularly kept up to date) to provide an adequate level of estate planning certainty. The comparisons in this paper therefore largely focus on a reversionary account-based pension versus a non-reversionary account-based pension with a binding death nomination in place.

Firsttech comment

In situations where a client has made a reversionary pension nomination and also a binding death benefit nomination on the same superannuation interest, there is uncertainty as to which nomination takes precedence in the event of death.

To avoid this uncertainty and any unintended consequences, clients should avoid putting in place both nominations over the same superannuation interest, and should elect to either have a reversionary pension, or a binding death nomination.

SIS Death Benefit Payment Standards

Regardless of the type of nomination selected, the SIS death benefit payment standards always apply.

Broadly, the SIS death benefit payment standards require:

- death benefits to be paid only to dependants or the member's legal personal representative (LPR) in almost all cases
- death benefits paid to a member's LPR, or adult children (unless under 25 and financially dependent, or disabled) to be paid as a lump sum.

Any nomination that would otherwise require these rules to be breached is invalid.

Advantages – automatic reversion

Reversionary pensions have a number of practical advantages over non-reversionary pensions. These include:

- The trustee is bound by the requirement to revert the pension to the reversionary beneficiary, which can save time and effort as there is no trustee discretion regarding either to whom the benefit may be paid or whether it is to be paid as a lump sum or pension.
- There is less paperwork likely to be required upon death in the case of automatic reversion. A death certificate and relationship declaration along with trustee minutes confirming the member's death and reversion of the pension is all that is likely to be required.
- There is no requirement for the reversionary pensioner to receive a pro rata minimum pension payment for the first part of the financial year of the pension following the pensioner's death (the pensioner's minimum, calculated at 1 July of the financial year, continues to apply for the entire year).

Estate planning certainty

Under super death benefit payment rules, in most cases where a member wants their pension benefits paid to a surviving spouse, there is little difference from an estate planning perspective between:

- commencing a reversionary pension with a spouse as the reversionary beneficiary
- commencing a non-reversionary pension and nominating the spouse to receive any death benefit under a binding death benefit nomination.

However, in some situations there are important differences.

Increased certainty of valid nomination for SMSF clients

Automatic reversion

For members of large super funds, reversionary pensions and binding death nominations provide broadly the same certainty that the right beneficiary will receive the deceased member's super on death. However, members of SMSFs may have more certainty through the use of a reversionary pension.

The terms of a reversionary pension are agreed to when a member commences their pension and is valid

from that date. This means that where the pension has been paid successfully to the pensioner for a period of time, the continued payment to the reversionary beneficiary upon their death should be straight forward, provided the reversionary beneficiary is a dependant of the pensioner.

Binding death benefit nomination

In contrast, binding death nominations may be readily accepted by the trustee when made, but may not be tested for validity until a member's death benefit becomes payable. Some SMSFs' governing rules may have specific criteria that need to be met when making a valid binding death nomination. If it is found at the time of paying the death benefit that not all criteria have been complied with, the nomination may be invalid and the death benefit could be payable to other beneficiaries or the member's estate.

Example 1

In Donovan v Donovan (2009) QSC 26, the Court found an SMSF member's nomination to not be binding because there was a lack of specific language indicating an intention to bind the trustee regarding the nomination.

The Court also found that even if it was intended to be binding, the nomination would have been invalid because the Fund's trust deed was worded in such a way that it required binding nominations to be made in accordance with SIS Regulation 6.17A (a Regulation that does not automatically apply to SMSFs) and the nomination had not met this requirement.

Where members of a couple die in close proximity

Where a couple die at the same time, a reversionary pension can ensure their estate planning wishes are carried out as intended, while a binding death benefit nomination may lead to unintended consequences.

Example 2

Susan and John (aged 63 and 62) are a couple. They have one child together (Mel - aged 18). Susan has an account-based pension running through a large super fund. She also has two adult children from a previous relationship (Grant – age 28 and Dana – age 26) who she has made provision for from her non-super assets in her Will. Susan wants to ensure that only John (or Mel in the future) benefit from her account-based pension balance. She therefore puts in place a binding death nomination nominating John as her beneficiary.

Binding death benefit nomination

Susan and John are in a car accident – Susan dies at the scene, while John dies a few days later in hospital. When the super fund trustee considers Susan's binding nomination, they find it is no longer valid as it is not possible to pay the benefit to John. It is also not possible to pay to John's estate under super law as John's legal personal representative (his sister Margaret) is not a dependant of Susan.

The fund's default provisions then apply, which in this case requires death benefits to be paid to a deceased member's legal personal representative (LPR). Susan's death benefit forms part of Susan's estate and is used to benefit Grant and Dana, with Mel receiving nothing.

Automatic Reversion

Alternatively, Susan could have made John a reversionary beneficiary of her account-based pension. In contrast to a binding death nomination, Susan's pension would automatically revert to John immediately upon her death, and would not need to be paid to her estate.

Upon John's death (a few days later) the account-based pension (now his) is subject to the fund's default rules, and is paid to his legal personal representative to be distributed according to his Will. Provided John's Will made provisions for Mel, she is able to benefit from Susan's account-based pension.

Susan could have therefore more comprehensively ensured that John and Mel (and not Grant and Dana who she has already made provision for) benefit from her account-based pension in the event of death by using a reversionary pension strategy.

Trap: minor child as a reversionary beneficiary

While the normal course of action is to nominate a spouse as a reversionary beneficiary, in some cases pensioners may want their pension to revert to other eligible beneficiaries, such as financial dependants, interdependent relations, or a minor child.

While a child under 18 is eligible to receive a death benefit as an income stream, it is important for the pensioner to realise that their reversionary pension will no longer be eligible to revert to the child once they reach 18, or reach 25 (if financially dependent), unless the child is disabled.

Pensioners should therefore generally avoid having a child as a reversionary beneficiary, and may instead consider a binding death nomination which allows the trustee discretion to pay a lump sum where that is the only SIS payment option available for the child, without the nomination becoming invalid.

Trap: reversionary TTR income streams

From 1 July 2017, a death benefit can only be paid as a pension where it is a retirement phase income stream.

In the case of a transition to retirement (TTR) income stream, it will only be a retirement phase income stream where the beneficiary has:

- Reached age 65 or
- Notified their super fund that they have satisfied the retirement, terminal medical condition or permanent incapacity condition of release.

In the case of a reversionary TTR income stream, it is therefore not possible for the income stream to continue to be paid to a reversionary beneficiary who has not met one of these requirements. In such cases, the reversionary nomination will be invalid and the fund's default provisions may apply.

With a TTR income stream technically remaining a TTR income stream even once the original pensioner has met a full condition of release, it continues to remain subject to these requirements in the case of reversion.

The quote

A death benefit income stream will count towards the recipient's transfer balance account and may leave them in breach of their transfer balance cap.

Example 3

Paul (age 60 and retired) commenced a TTR income stream 5 years ago. His spouse Fiona (age 55) is the reversionary beneficiary.

In the event that Paul dies, the TTR income stream (if paid to Fiona) cannot be a retirement phase income stream as Fiona is not aged 65 and has not satisfied another eligible condition of release. As a result, the TTR income stream cannot be paid to her and the reversionary nomination is invalid.

The super fund's default provisions would therefore apply to determine where Paul's death benefit is paid.

Firsttech comment

Where the reversionary spouse is unlikely to meet one of the specified conditions of release, clients should consider not setting up a reversionary TTR income stream and instead electing to use a binding death nomination.

Where a client already has a reversionary TTR income stream (including where they have since met a full condition of release), they should consider:

- Removing the reversionary nomination (if allowed by the provider) and replacing it with a binding death nomination or
- Stopping their TTR income stream and commencing a new account-based pension (if eligible to do so).

Note – at the time of writing FirstTech is aware that several industry participants have appealed to the Federal Government to amend the rules to allow a TTR income stream to revert to a reversionary beneficiary regardless of their circumstances. Therefore, before removing a reversionary nomination or stopping and starting a pension, an adviser may wish to double check to see whether these rules have been modified.

Transfer balance cap

Under the transfer balance cap rules introduced from 1 July 2017, a death benefit income stream will count towards the recipient's transfer balance account (TBA) and may leave them in breach of their transfer balance cap.

To avoid or fix this issue, the death benefit beneficiary will need to action one or more of the following:

- move some of their existing retirement phase income streams back to accumulation phase (or cash them out)
- receive part or all of the death benefit as a lump sum death benefit
- receive a death benefit income stream, which is then partially or fully cashed out as a lump sum death benefit.

For transfer balance cap purposes, reversionary and non-reversionary death benefit account-based pensions are treated differently.

Transfer balance cap credit for death benefit income stream

	New death benefit account-based pension	Reversionary death benefit account-based pension
How much counts towards TBA	Starting balance	Balance at date of death
When does it count towards TBA	Date of commencement	12 months from the date of death

Note: Table assumes death occurs on or after 1 July 2017.

In most cases, where a client dies with a non-reversionary account-based pension, their super fund would be expected to pay a new death benefit income stream to their nominated beneficiary well within 12 months.

Reversionary beneficiaries of account-based pensions therefore generally have an advantage under the transfer balance cap rules, as they have additional time with which to arrange their affairs (e.g. roll part of their existing retirement phase benefits back to accumulation phase), and generally allows them to keep more in retirement phase for longer.

Reversionary beneficiaries may also have smaller credits towards their TBA than nominated beneficiaries receiving new death benefit income streams. This applies in situations where the deceased member's balance increases, such as due to the allocation of investment returns, between the date of death and the date any new income stream would be commenced.

Life insurance funded from a reversionary account-based pension

Because the value of a reversionary account-based pension at the date of death counts towards the reversionary beneficiary's transfer balance account (with a 12 month delay) a strategy that may be effective in maximising the beneficiary's retirement phase benefits without exceeding their transfer balance cap, is to fund any required life insurance from their account-based pension.

In this case, after the account-based pension reverts to the beneficiary, insurance proceeds are then allocated to the account sometime after the date of death. As a result, while the beneficiary benefits from the increased retirement phase balance, the proceeds appear to not be included in the amount credited to their transfer balance account.

In contrast, where a client had life insurance premiums funded from a non-reversionary account-based pension, the value of any new death benefit income stream paid to a nominated beneficiary (and credited towards their transfer balance account) will already include the value of the insurance proceeds.

Firsttech comment

This strategy is only effective if the client has commenced an income stream and requires life insurance.
Often clients who are in pension phase do not require life insurance as they may be debt free, have few dependants and/or have accumulated sufficient assets.

For the strategy to be effective the insurance premiums must be paid from the account-based pension, not an accumulation account. This ensures the insurance proceeds increase the balance of the account-based pension rather than the deceased's accumulation account.

As this is new legislation, prior to implementing this strategy clients should request a private binding ruling from the ATO to verify the transfer balance cap assessment.

Tax

The ATO confirmed in Tax Ruling TR 2013/5 that:

- Where a pension automatically reverts to a reversionary beneficiary, the pension will not cease upon the pensioner's death
- Where a pension does not automatically revert to a reversionary beneficiary, the pension ceases upon the death of the member.

The timing of the cessation of an account-based pension is critical because it determines whether assets sold / transferred by the super fund in order to pay a death benefit are subject to CGT, and how tax components within a deceased member's benefit are calculated between the time they died and when their death benefit is paid.

To address the consequences associated with non-reversionary pensions ceasing on death, the government made regulations applying from 1 July 2012 that sought to provide equivalent treatment to assets supporting non-reversionary pensions upon a member's death.

The regulations apply to non-reversionary pensions that, as soon as practical after the deceased's death, are either paid as a lump sum or a new death benefit pension. The regulations:

- Allow the tax exemptions that apply to earnings on assets supporting income streams to be extended from the date of death until the payment of the lump sum or the commencement of the new pension, provided this happens as soon as practicable. This excludes any earnings from insurance proceeds or anti-detriment amounts added to the interest.
- Allow the tax components of the deceased member's super interest to remain subject to income stream proportioning rules from the date of death until the payment of the lump sum or the commencement of the new pension, provided this happens as soon as practicable. This excludes any insurance proceeds or anti-detriment payments, which are always added to taxable component.

Example 4

Gregory (age 56) has an account-based pension balance of $500,000 in his SMSF (80% tax free component). His spouse Heidi (age 50) is the reversionary beneficiary of his pension. His fund also holds $1 million of life cover for him, with premiums funded from his pension interest.

Greg dies and his pension automatically reverts to Heidi. The new balance (including life insurance proceeds) is $1.5 million. However the pension maintains its 80% tax free proportion. This means that 80% of future pension payments to Heidi are tax free component, and 80% of any future lump sum commutations or death benefits are tax free component.

In contrast, if Greg's pension was not reversionary and his death benefit is paid as a new pension to Heidi (e.g. because of a binding death nomination), the insurance proceeds would need to be allocated only to taxable component. This means the tax free proportion of Heidi's new pension would be 26.67% ($400,000 / $1.5 million).

To highlight the potential future impact, let's assume that Heidi dies in 10 years' time, at which point her remaining pension balance at the time of $1.1 million is paid as a lump sum to her adult child, Kim. Had the pension automatically reverted to Heidi, her death benefit would be $880,000 tax free component, while the binding death benefit nomination option would see a tax free component of $293,370. By using a reversionary pension strategy in this situation, Heidi's death benefit is subject to $99,727 less tax when paid to Kim.

The quote

Timing of the cessation of an account-based pension is critical because it determines whether assets sold … to pay a death benefit are subject to CGT.

Tip: reversionary pensions allow life insurance to be allocated proportionally across tax components

Clients who have an account-based pension with life insurance attached may benefit from choosing a reversionary pension because any life insurance proceeds allocated to their super interest after death will be allocated proportionally between tax components.

Trap – fully commuting a reversionary pension

Where a death benefit is paid as a reversionary pension, the beneficiary may wish to commute part or all of the balance to a lump sum.

However, it is important to note that TR 2013/5 confirms that a pension ends upon a full commutation request taking effect. The ATO confirms that this occurs prior to the commuted lump sum being paid. This means that, upon receiving the commutation request, where the fund has to sell assets to pay the commutation, or pays the commutation by in specie transfer of assets, the fund's assets are no longer supporting a superannuation income stream and, particularly where the fund is using the segregated pension assets approach, significant capital gains tax consequences may apply.

In contrast, where a death benefit is payable under a binding death nomination, the beneficiary can generally elect to receive any lump sum without needing to use the balance to commence a pension. Where this occurs, and the fund pays it as soon as practicable, the regulations deem the balance to be in pension phase up to and including when the lump sum is paid, meaning a CGT exemption can apply.

Where a beneficiary may potentially need to convert their pension to a lump sum, it may be prudent for the pensioner to use a binding death nomination instead of a reversionary pension.

Alternatively, a reversionary pensioner who wishes to make a lump sum commutation from their pension should ensure:

- the fund sells any assets required to fund the commutation prior to the commutation request being made, or
- any commutation request made is for a partial commutation rather than a full commutation.

Social security Assets test treatment

Account-based pensions have always been fully assessable under the social security assets test. This treatment applies in the same way regardless of whether a surviving spouse receives a continuation of their deceased spouse's account-based pension via a reversionary pension arrangement, or commences a new pension upon being paid their death benefit.

Pre 1 January 2015 account-based pensions

Under the previous income test rules, assessable income included any pension payments received during a financial year, less a deductible amount.

The deductible amount was determined by the following formula:

$$\frac{\text{(Purchase price – commutations)}}{\text{Relevant Number}}$$

Where Relevant Number is:

- The life expectancy of the pensioner at commencement (where no automatic reversion)
- The longer life expectancy of the pensioner and reversionary beneficiary at commencement (where automatic reversion)

Upon the death of the pensioner, a reversionary pension continues to be paid with the same deductible amount to the reversionary beneficiary. Where no automatic reversion was in place, any new pension paid to a beneficiary upon the death of the pensioner would have a new deductible amount calculated with reference only to the beneficiary's circumstances.

Example 5

Al and Rhonda are age pensioners both aged 67. Al commenced a non-reversionary account-based pension with a purchase price of $300,000 on 1 July 2013 via his SMSF. He has nominated Rhonda to receive his death benefit via a binding death nomination. His social security deductible amount is $15,609 pa ($300,000 / 19.22). He draws an annual pension payment of $18,000 (via regular payments throughout the year) and his current account balance is $270,000. For social security income test purposes, he has assessable income of $2,391.

The SMSF's rules allow him to add a reversionary beneficiary to his account-based pension without recommencing it. If he adds Rhonda as his reversionary beneficiary, the deductible amount of the pension would become $13,605 ($300,000 / 22.05). The social security assessable income of his pension going forward will change to $4,395, an increase of $2,004. This results in a maximum combined loss of age pension of $1,002 pa.

If Al dies and he had not added a reversionary beneficiary, his $270,000 account-based pension balance would likely be paid to Rhonda as a new account-based pension. Assuming a deeming rate of 3.25% pa, this pension would have social security assessable income of $8,775 pa. In contrast, if Al had added Rhonda as a reversionary beneficiary, the pension would still be grandfathered and would have assessable income of $4,395. In this situation, the decision to appoint Rhonda as a reversionary beneficiary means $4,380 less assessable income, and a maximum of $2,190 pa more age pension.

This example highlights that Al and Rhonda could give up $1,002 pa in age pension while Al remains alive, in order to gain $2,190 in age pension if he passes away. Clearly the best course of action will depend on how long Al lives and whether Rhonda outlives him.

Income test treatment

From an income test perspective, a significant change occurred on 1 January 2015 with deeming rules applying to account-based pensions from that time. Where an account-based pension is deemed for income test purposes, it makes no difference whether the pension is reversionary or not.

Grandfathering of deductible amount rules

The previous rules were grandfathered and continue to apply where a pensioner:

- has been in receipt of an eligible income support payment (e.g. the age pension) since immediately prior to 1 January 2015, and
- commenced their account-based pension prior to 1 January 2015.

Grandfathered status also extends to situations where an account-based pension that was grandfathered in the pensioner's hands automatically reverts to a reversionary beneficiary, provided the beneficiary is in receipt of an eligible income support payment at the time of reversion and continuously receives an eligible income support payment from that time.

Where a grandfathered income stream ceases, any new income stream commenced in the future will be subject to deeming.

Adding a reversionary beneficiary to extend grandfathering status

Where the governing rules of the super fund allow a reversionary beneficiary to be added to an existing account-based pension without requiring it to be recommenced, Centrelink will recalculate the deductible amount based on the original purchase price and the longer life expectancy (at commencement) but only apply the new deductible amount to future payments.

Importantly, because the original account-based pension has not been recommenced, a grandfathered account-based pension can have a reversionary added to extend the grandfathered status for the life of the reversionary beneficiary, provided they continuously qualify for an eligible income support payment from just before the time of reversion.

The quote

Where a couple die at the same time, a reversionary pension can ensure their estate planning wishes are carried out as intended.

When considering this strategy, a pensioner generally needs to weigh up the potential loss of social security pension now (as a result of the reduced deductible amount) against the potential increased social security benefits after reversion (as a result of the extended grandfathering) as the following example shows.

Firsttech comment

Some additional considerations in this comparison are:

- The reversionary beneficiary may have a lower life expectancy than the primary beneficiary, meaning no increase in assessable income as a result of adding them to the pension.
- Clients might have their pension determined under the assets test. This could result in no reduction in age pension due to adding a reversionary beneficiary. In addition, if they are asset tested once the client passes away, adding a reversionary beneficiary may not result in additional age pension payable.
- Clients may be able to minimise the amount of income assessed from their grandfathered pension for social security purposes by taking income above the deductible amount (subject to minimum payment requirements) either as a lump sum commutation or as an increased pension payment late in the financial year. Where this is possible, the increase in assessable income as a result of a change in deductible amount may be minimised or eliminated.

Trap: reversionary pension to spouse may make them ineligible for age pension upon death of pensioner

Where one member of a couple dies, the surviving spouse can often find themselves assessed against a single person's income and assets test thresholds, while retaining the same level of assets and income as when they were a couple.

It may be in a client's interests to ensure that their superannuation passes to their estate in the event of death, rather than to their surviving spouse. This is not possible with a reversionary pension, and instead would commonly require a binding death nomination with the LPR as the recipient. **FS**