Supervision GROUP Est. 2002

Pension Commencement

RULES AND OBLIGATIONS

Introduction

If you have received advice (from your financial adviser) on starting a Pension, please use this document as a practical guide to compliment the advice you have already received. For those without an adviser, this document is designed to give you some additional information that you may not have considered. We remind readers that Supervision is not providing advice on whether a pension is right for you or encouraging you to start a pension. For some people, starting a pension may not be practical or advantageous.

What is a Pension?

A pension (or pension phase) is simply where you draw money from your SMSF to meet your day to day living needs. It may cover 100% of your lifestyle requirements, or form part of a wider strategy that includes your personal assets and/or Government assistance. Depending on your age and working circumstances a pension can be paid to you whilst you are receiving salaried income- transition to retirement.

Purpose of a Pension

The purpose of a pension is to provide an aspirational lifestyle in retirement. This means that Superannuation is used for the purpose that is intended; retirement income.

The decisions you make as Trustee (when members enter pension phase) need to strike a balance between responsible spending and a desirable lifestyle. Investment strategy documentation should take into account these requirements and required changes.

To start a pension, we require you to complete a pension request form on our website. This form includes all the information that we need to set up a pension for your SMSF.

It is important to know that creating a pension is **not final**. Pensions can be closed at any time depending on the requirements of the member. Pensions are not compulsory, so it is prudent to analyse if a pension is right for you. There are some circumstances where it may not suit your current circumstances

This fact sheet assumes that you are eligible to start a pension- which means you have met a condition of release. Please see our fact sheet for the various conditions of release.

What to Consider about Pensions?

Tax Reduction - 0% tax rate for Pension Accounts

Members that convert their member balances to a pension, reduce the members taxation rate (tax on income & capital gains) from 15% down to NIL.

It is difficult to estimate the amount of tax that an SMSF will save if a member/s enter into pension phase. The amount of SMSF tax saved depends on the **size of the member's account** and the **amount of income** that is created in the SMSF.

If the member converting to pension makes up the majority of the SMSF's value (i.e. SMSF value = $1,600,000, Member Value = $1,000,000) then the SMSF will cut existing tax payable significantly. If the member has a smaller portion of the SMSF value attributed to their members account, then the SMSF's tax savings will be lower.

If the SMSF is not generating income (cash income or capital gains) then the amount of taxation that is saved will be minimal. Alternatively if the income of the SMSF is high then adding pensioners to the SMSF will result in a reduction in tax. Understanding current SMSF tax will give you an indication of how much you may be able to save.

If two members create a pension and their combined balance equals 100% of the SMSF's value, then 100% of the SMSF's current taxable income will be reduced to NIL. If the SMSF does not pay tax (100% pension phase), then any franking credits received by the SMSF will be refunded at tax time.

Pension Minimum

Each year you are required to take a fixed amount (cash) out of your members account to satisfy your pension minimum. Effectively, your SMSF income is given tax free status. In return the Government expects that over time you use your Superannuation for the purpose in which it was created- to provide for your retirement income needs. **This is an annual requirement that is based on your member balance on the 30th of June in the previous year multiplied by a fixed percentage (based on your age).**

History shows, that various Governments reduce (usually halve- 50%) the pension percentage when economic conditions warrant. When economic shocks (like COVID) create downward market movements, the Government will not force pensioners to sell down capital assets to meet pension minimums. These decisions are always arbitrary and apply across the board regardless of what assets are in your SMSF portfolio.

As there are no maximum withdrawal amounts for "Account Based Pensions", if you need money from your SMSF to meet your living requirements, you can still withdraw that money to suit your circumstances.

When you enter pension phase, you need to consider the amount of "cash money" that you must withdraw each year. If your SMSF is not currently creating enough cash money (cash income like dividends, interest, distributions, rent etc.) to cover the minimum requirement, either a change of investments or sell down of capital assets is required to meet the members requirements. For example, if your pension requirement is $25,000 per year, but your SMSF is only providing $20,000 in dividend/interest income, the Trustee needs to make changes to meet the members requirements for income **OR** members need to consider ceasing pensions to reduce minimum requirements. What you decide needs to be written in your investment strategy document.

Property assets that have low yield and low liquidity (low net rental incomes & can't be sold quickly) can create problems for SMSF's that need to meet members cash pension requirements. Planning can be done to reduce pension requirements to suit the investments, however the point of Superannuation is to create desirable lifestyles for members not force them to be satisfied with the amount of income created by the SMSF and live accordingly.

Supervision will inform you of your pension minimum each year as part of your previous years tax return and will also allow you to view your pension withdrawals online through our accounting software. We send reminders to clients before the end of the financial year in order to make sure they cover their pension minimums.

Not Meeting your Pension Minimum

If you do not meet your pension minimum, your pension income will not be exempt from tax. Your SMSF will pay the same amount of tax as if it is in accumulation phase. Your pension will cease and you will need to start another pension in the following year (if a pension is still right for you).

Pension Withdrawals

You do not need to take your pension in regular amounts or each month. Rules dictate that you meet your pension minimum at the very least each financial year. So, if your annual pension minimum is $15,000 you can choose to take that minimum in what ever combination of payments (ex. 1 X $15,000, 2 X $7,500, 4 X $3,750, 12 X $1,250 or any combination of these), as long as the minimum $ has left the SMSF in cash before the 30th of June each year. How often you choose to take your money will depend on your personal lifestyle requirements.

Investment Strategy Documentation

Your investment strategy is the "business plan" for your SMSF. When you start a pension, your "business" needs to cater for the members "cashing" requirements. Pensions require liquidity to function, so including information in your investment strategy about liquidity is vital. Supervision's investment strategy builder (available on our website) asks Trustees to detail their SMSF's current liquidity capabilities and outline what they would do if the members require greater cash from the SMSF. There are no wrong of right answers that you create in your investment strategy, only what is right for the members.

We recommend that you review your investment strategy in the light of increased liquidity requirements of pension establishment. Depending on the investments already residing in your SMSF, you may not need to make changes to those assets when you start a pension. You may however want to acknowledge the members requirements for cash and what the Trustees plan to do if certain market or life events occur.

Capping of Amount in Pension Phase $1.9 Million (from 30th June 2023)

Superannuation does not have a cap on how much you can put into it. You are able to accumulate as much money into Superannuation as you are capable or willing.

However the amount that you can place into pension phase is capped for each member. The reason is simple. Income created by pension accounts is tax free, so the Government deem that $1.9 Million should create an amount of income that should fairly remain tax free. Any amounts that the member has will remain in accumulation phase and that income will be subject to 15% Tax.

For example (illustration purposes only- calculations are more complex than below)

Phil has a member balance $2.5 Million (creating $125,000 income) in Superannuation, and starts a pension with $1.9 Million.

$1.9 Million in Pension phase is 76% of the members balance.

$125,000 X 76% = $95,000 income is tax free.

The remaining $35,000 income will be taxed at 15% = $5,250 tax payable.

Total tax rate ends up at 4.2% ($5,250 tax / $125,000).

How is my tax calculated if I have pension and accumulation?

When the SMSF has a combination of pension and accumulation accounts, calculations need to be completed to determine the amount of tax free income. At tax time, Supervision will apply for an actuarial certificate which is required to allow tax deductions in the tax return. There is an additional cost of $165 each year for this certificate.

Can I still contribute to Super if I have a pension?

Yes, if you are eligible to contribute to Superannuation, you will be able to put money into Superannuation. All new contributions will need to go into accumulation phase and can only be released or combined into another pension if the member meets another condition of release. Combining pensions will require the original pension to cease.

Process- How does it work

Step 1. In order to start a pension you (or your adviser) can apply using our pension commencement form on our website.

https://supervision.com.au/pension-commencement-form/

How to complete the pension commencement form

A) Please make sure you enter the details of your SMSF correctly- This is an official application process.
B) You may have questions about the following:
- Conditions of Release- please refer to our "Conditions of Release" info sheet
- Reversionary Beneficiaries- please refer to our "Reversionary Beneficiary" info sheet or speak to your financial adviser

C) Submit the application and your pension commencement will begin. ($250/Pension)

Step 2. Supervision will process any unmatched transactions and balance the whole SMSF to determine the members balance on the pension commencement date. If any major unlisted assets (property or unlisted shares) have not been valued in recent times, you may be asked to value those assets.

Step 3. Supervision will send you pension documents to sign. These documents will need to be sent back to Supervision for filing in your permanent records.

Step 4. Arrange pension withdrawals with your online bank or ask your adviser.