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Pain for retirees with defined benefit pensions

Expert view

John Wasiliev

Based on feedback from last weekend's column, the government's proposed reforms for defined benefit (DB) pensions have come as a major surprise to many who have these classic superannuation income arrangements in place.

The big surprise is in the proposal to establish a capital value for DB super pensions and the lower concessions this will mean for higher-income earners, including judges, politicians and senior public servants. The proposed rules will particularly hit individuals who also have private super arrangements, such as a self-managed fund or an account with an industry super fund.

The column prompted a range of questions as basic as "Where did this information come from?" and "Where can I get further information?"

One that neatly summarised a possibly common scenario came from a pensioner of the Commonwealth Superannuation Scheme (CSS), a major DB scheme.

The issue that caught the pensioner's eye was the proposal to multiply DB pensions by a factor of 16. If this calculation exceeds the proposed $1.6 million tax-free super pension limit, some money will need to be switched back to the accumulation phase and subjected to tax.

This planned pension multiplier makes the reforms relevant for anyone who receives an annual income stream of $100,000 or more.

The reader continued: "You may know that CSS pensions are made up of a government share (described as an unfunded amount because the government doesn't actually set aside money, but rather makes a promise to pay the income in the future) and an employee share (described as a funded amount because it comes from extra contributions employees make, and which go into a managed super fund).

"At retirement a person can receive a standard indexed pension amount (from their government entitlement) with the option of receiving either a refund of their contributions and interest, or using that amount to purchase an additional, non-indexed pension.

"In my case I elected to purchase additional pension and it is only because of this decision that my total annual pension is brought to over $100,000. My query is whether the government is likely to distinguish between the different make-up of pension amounts in this situation?"

Nerida Cole says changes to defined benefit super will impact those who also have private arrangements. PHOTO: JAY CRONAN

Along similar lines, another reader asks: "My (defined benefit) pension is made up of two components, one that is indexed and one non-indexed. Your article makes no distinction between indexed and non-indexed portions. I would have thought that they should be treated differently. Have you any comment?"

In response, Nerida Cole of Dixon Advisory, a financial planning firm with expertise in both DB and private super pensions, believes that regardless of whether the pension comes from unfunded or funded sources, the 16 times multiplier formula will apply to the pension income.

If anyone with a private super arrangement, such as a self-managed fund or an industry fund account, has accumulated more than $1.6 million, any excess will be subject to tax in the pension phase. Where they have a DB pension, the 16 times pension multiplier rule will apply.

If you happen to have a DB pension

> *Recipients of DB pensions cannot have two bites of the tax-free pension cherry.*

generating an annual income of less than $100,000 but you also have money in private super, these will in future be assessed together for the purposes of the pension balance limit.

The value of private super can be easily established. The 16 times pension multiplier will give the DB pension a lump sum value that will be assessed against the $1.6 million tax-free pension allowance.

Where someone has a combined DB pension/private super pension with a total amount above $1.6 million, they will need to adjust this by rolling back some of their private super to an accumulation account. Where the annual DB pension exceeds $100,000, all of their private super might need to be rolled back.

In other words, recipients of DB pensions cannot have two bites of the tax-free pension cherry. They can't have a DB pension and up to $1.6 million in a private super account and not bear any extra penalty compared to a private sector employee who might just have the $1.6 million in super.

Where the DB pension is above $100,000, new tax rules will apply with varying rates of extra tax depending on whether the pension is from a funded or unfunded source.

Under present tax rules, a DB pension from unfunded super is taxed at full marginal tax rates with a 10 per cent tax offset. The offset can be deducted against the tax bill. A $100,000 pension, for instance, is entitled to a $10,000 offset against tax owing.

Under the proposed rules, where the unfunded pension exceeds $100,000 any excess will be fully taxable with no extra offset. This means the maximum tax offset will be $10,000.

When a DB pension is sourced from a taxed fund, half of any extra income above $100,000 will be included in taxable income and taxed at the marginal rate.

For readers who asked whether their DB fund will be captured in the new rules, Cole says it more than likely will be. For those unhappy with these changes, now is the time to lobby federal politicians.

According to Stuart Forsyth of McPherson Super Consulting, the legislation is a consultation draft and the outcome may change.

For anyone who wants a link to the DB pension changes in the draft legislation, please email me at john.wasiliev@fairfaxmedia.com.au