Market-linked pensions are now fully commutable

Benefits, risks and key steps when terminating legacy pensions

Michael Hallinan

A significant change has occurred in relation to market-linked pensions. These pensions can now be terminated with the consequence that the member account balance previously supporting the pension can be either cashed out, retained in the fund as an accumulation phase, or the account balance used to commence an account-based pension.

However, this opportunity to escape the restrictions of market-linked pensions is strictly limited and will close on 6 December 2029. So, this is an all-or-nothing opportunity—the pension must be fully terminated or not terminated at all.

Both trustees of superannuation funds that are paying market-linked pensions and members who are currently receiving market-linked pensions should consider whether to escape the confines of these pensions and liberate the account balance currently supporting them.

But first, the complexities and issues of terminating market-linked pensions must be considered and this is the subject matter of this article.

Hyphenated or not?

First and most importantly—are they or are they not hyphenated? If you follow the legislation there is no hyphen, but if following style guides it should be 'market-linked pensions', as is used in this article.

What are these hyphenated pensions?

Market-linked pensions could be issued on or after 20 September 2004 by all types of complying superannuation funds and incorporated three significant features in relation to the superannuation regime which operated from 1994—from the introduction of flat dollar reasonable benefit limits—until 2007 when the 'Costello Simplified Super' changes *[under the Tax Laws Amendment (Simplified Superannuation) Act 2007]* commenced on 1 July 2007.

1. Complying pensions

The first significant feature was that these pensions were treated as being 'complying pensions', potentially enabling the member to choose the more generous *pension* reasonable benefit limit—rather than the *lump sum* reasonable benefit limit (RBL)—applied when determining if the benefit was excessive and the amount of that excess. The pension reasonable benefit limit was twice the size of the lump sum limit.

2. Centrelink asset test exemptions

These pensions could, if additional requirements were satisfied, have special Centrelink asset test treatment, being 50% asset-test exempt. Before 20 September 1998 all superannuation pensions, apart from allocated pensions, were asset-test exempt. On and from 20 September 1998 only certain kinds of defined benefit pensions were asset-test exempt.

3. Restructuring of defined benefit pensions
Defined benefit pensions could be restructured as market-linked pensions while retaining asset-test-exempt status. This simply meant that either the entire pension balance was excluded from the asset test (100% exempt status) which previously applied to defined benefit pensions, or half of the pension balance was excluded (50% exempt status) from the Centrelink asset means test.

Key features of market-linked pensions

Market-linked pensions were an account-style pension, payable for a fixed term which could only be a whole number of years and related to the life expectancy of the member. As an account-style of pension, an account within the fund was established. The amount applied to commence the pension was treated as the initial account balance, earnings were added to the account, and pension payments were debited to the account.

The total pension payments that could be made in a financial year had to be within a 10% margin (plus or minus) of an amount obtained by dividing the pension account balance at the start of the financial year by a specified factor that was related to the number of years remaining in the term of the pension.

At the end of the fixed term, the pension ceased and any balance in the account had to be paid to the member within 28 days.

There was no guarantee that the pension would be paid for the entire period of the fixed term—if the pension account was exhausted before the expiration of the term, the pension would then cease.

The pension could only be commuted to 'rollover' the pension into another market-linked pension, whether in the same super fund or another super fund.

If the pension was reversionary then the fixed term of the pension could be related to the life expectancy of the reversionary beneficiary, assuming the reversionary beneficiary of the pension had a greater life expectancy than the member.

When were they introduced?

Market-linked pensions were introduced in 2004, and they could be issued on or after 20 September 2004. They were introduced to provide a "less complicated and more flexible option for retirees wanting a complying income stream", (quoted from then-Treasurer Peter Costello's policy statement, *A More Flexible and Adaptable Retirement Income System*, 25 February 2004).

As market-linked pensions were account style pensions—not defined benefit pensions—they could be issued by self managed superannuation funds (SMSFs).

Why were market-linked pensions used?

The first reason market-linked pensions were used was that the pension was treated as a 'complying pension' which meant that the pension permitted the member to be eligible (if a sufficient portion of super benefits were taken as complying pensions) for the pension RBL to apply to the member, rather than the lower lump sum RBL.

The second reason was that these pensions could have 50% asset-test-exempt (ATE) status, if they satisfied some additional requirements of the *Social Security Act 1991.* This meant that only 50% of the pension balance was counted for the purposes of the Centrelink asset means test.

Unfortunately, the Costello Simplified Super changes that applied from 1 July 2007 removed these advantages. Market-linked pensions issued before 20 September 2007 (the end of the relevant transition period) could continue after 20 September 2007 and if they had 50% ATE status, that status continued.

However, new market-linked pensions could only be issued after 19 September 2007 if the account balance for the new pension was entirely sourced from another market-linked pension or another type of complying pension. Generally, market-linked pensions issued after 19 September 2007 did not have any ATE status.

Again, unfortunately, as market-linked pensions were not commutable (except in very limited circumstances which are not presently relevant) they could not be commuted and cashed out or used to commence either an allocated or account based pension.

Why still use them?

After the Costello Simplified Super changes, market-linked pensions only had attractions for individuals who wanted to and could (because there was no adverse Centrelink consequence) transfer from other more restrictive types of complying pensions—such as lifetime pensions and life expectancy pensions—as these pensions could be commuted so long as the commutation amount was entirely applied to commence a market-linked pension.

Market-linked pensions were less expensive to operate than the other two types of complying pensions as no annual actuarial certificates were required. Additionally, if a defined benefit pension failed the actuarial solvency requirements, the pension had to be restructured into a market-linked pension (with no ATE status).

For market-linked pensions which had the 50% ATE status—this status was, at least initially, a very valuable feature.

But market-linked pensions which did not have 50% ATE status—could not be commuted and cashed out.

In short, the individual was caged in either because the cage was golden (50% ATE status) or simply a wire cage (with no ATE status).

The quote

This opportunity to escape the restrictions of market-linked pensions is strictly limited and will close on 6 December 2029.

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The quote

Market-linked pensions were less expensive to operate than the other types of complying pensions.

Why not simply continue the market-linked pension until expiration?

It is possible to simply continue the market-linked pension until the expiration of the term. But there could be good reasons to terminate the pension.

For large superannuation funds, paying for the systems to be maintained for a product that has a closed and declining market, would be hard to justify.

For self managed superannuation funds, again the cost of maintaining the pension and the fact that the pension is non-commutable and cannot be rolled over to another fund (for instance, due to a small pension balance) means the fund has to remain in operation when it would otherwise be wound up.

What could be done to terminate market-linked pensions?

In the past, very little could be done to terminate market-linked pensions.

Rolling over to another market-linked pension

The initial response may be to commute the market-linked pension and pay the commutation lump sum to another superannuation fund to commence a new, replacement market-linked pension. While market-linked pensions can be commuted for this purpose, there are practical issues with this solution. First, there is no obligation upon any superannuation fund to accept such a transfer and the issue of the replacement market-linked pension. Many funds may prefer not to issue such pensions due to cost and systems issues. Secondly, the transfer amount may be below the minimum transfer amount that a super fund will accept.

Reducing the term

While a market-linked pension can be commuted and the commutation lump sum applied to issue a different market-linked pension from the same fund with a shorter term (if this is available to the member), this response does not solve the issue but merely, at best, reduces the remaining term of the pension.

Increasing the drawdown

Finally, can the market-linked pension be consumed at a quicker pace by increasing the pension drawdown in respect of each financial year? Unfortunately, this also will not solve the issue.

The rules applying to market-linked pensions specify an upper limit to the total pension payments within a financial year. This upper limit is 10% greater than the specified pension payments for a year. So there is little scope for increasing the pace at which the pension account balance is consumed. Further, the market-linked pension rules require the pension balance to be paid over the remaining term of the pension. Reducing the pension balance simply means that lower pension payments will be paid over the remaining term—it does not shorten the term.

Centrelink consequences

If the market-linked pension had 50% ATE status, then terminating the pension would give rise to potentially adverse Centrelink treatment. The age pension entitlement for the previous five years would be reassessed on the basis that the pension had no asset-test exemption entitlement, and if there has been an overpayment (which will usually be the case), the overpayment of the age pension for that period will be a debt due to the Commonwealth. Additionally, future age pension entitlement will be on the basis that the pension is fully asset-tested.

If the pension had no asset-test exemption, then the commutation of the pension would constitute a breach of the *Superannuation Industry (Supervision) Regulations 1994* (SIS Regulations) and may give rise to monetary penalties on the part of the trustee and possibly a review of the compliance status of the superannuation fund.

What can be done now? A great deal has changed

From 7 December 2024 market-linked pensions can be terminated and the underlying pension capital released to the member.

Regulations have been made—*Treasury Laws Amendment (Legacy Retirement Product Commutations and Reserves) Regulations 2024*—to permit all types of legacy pensions (including market-linked pensions) to be fully commuted.

Commutation window

The regulations provide a five-year window in which individuals can terminate non-commutable legacy pensions—such as lifetime pensions, life expectancy pensions and market-linked pensions—by fully commuting those pensions and either cashing out the commutation value, retaining the commutation value in accumulation phase or by commencing account-based pensions.

There are four significant points about this commutation window:

- First, the window is only open for five years and will cease on 6 December 2029.
- Second, there is no obligation on the part of either the trustee or the member to commute a legacy pension.
- Thirdly, the commutation must be a full commutation—the window does not apply to partial commutations.
- Lastly, if the pension is asset-test-exempt (either 50% or 100%), expert advice should be first obtained as to the Centrelink implications of the commutation of such pensions.

How can market-linked pensions be cashed out now?

There are five steps to cash out a market-linked pensions.

1. Trust deed/governing rules

First ensure that the trust deed/governing rules of the fund permit the cashing out of market-linked pensions. If necessary, the trust deed/governing rules will have to be amended to include the necessary powers.(1)

2. Minimum payment
Ensure that the pro–rata minimum pension payment for the relevant financial year has been paid.

3. Request to trustee
The relevant member then requests the trustee to commute the market-linked pension and specifies what is to be done with the lump sum arising from the commutation. The member could specify that the lump sum be paid out as a member benefit, or that the lump sum be retained in the fund/rolled over to another fund, or used to commence an account-based pension (subject to the member having sufficient transfer balance cap space).

4. Determine account balance
The trustee determines the account balance of the market-linked pension.

5. Commutation
The trustee commutes the pension and applies the account balance—which is the lump sum arising from the commutation of the pension—in the manner the member has specified.

Once cashed out, what can be done with the payment?

The lump sum arising from the commutation of the pension can be either:

- paid to the member as a superannuation member benefit—which given the age of the member will be tax-free, or
- retained in the fund as an accumulation interest in the superannuation fund (or another superannuation fund), or
- applied to commence an account-based pension, subject to the member's transfer balance cap space. Account-based pensions are fully commutable.

What are the tax and preservation components of the lump sum arising from the commutation?

The tax components will be determined by the tax-free percentage that applied to the pension prior to the commutation of the pension. It is assumed that all market-linked pensions that commenced before 1 July 2007 have now transitioned to the proportioning rule for calculating the tax-free and taxable components of pension payments.

The lump sum will be an entirely unrestricted non-preserved component.

How does the commutation affect the transfer balance account of the member?

This depends on whether the market-linked pension commenced before or after 1 July 2017 and in broad terms, the transfer balance debit will be determined as follows:

- If the pension commenced *before* 1 July 2017 (in which case, the market-linked pension is a capped defined benefit income stream)—the transfer balance debit that arises on the commutation of the pension will be the transfer balance credit of the pension (as at 1 July 2017) less the aggregate of all pension payments since 1 July 2017 in respect of the pension (including the pro-rata minimum pension drawdown for the financial year in which the commutation occurs).
- If the pension commenced *on or after* 1 July 2017 (in which case, the market-linked pension is *not* a capped defined benefit income stream)—then the transfer balance debit that arises on the commutation of the pension will be equal to the pension account balance immediately before the commutation.

What if the pension is asset-test-exempt?

If the market-linked pension is asset-test-exempt, then the commutation of the pension will generally have adverse Centrelink consequences.

If the member is receiving an asset-test-exempt pension and the commutation is *not* an allowable commutation (relevantly, a commutation other than in circumstances of Centrelink accepted hardship), then the market-linked pension will lose its asset-text-exempt status. Further, the member's entitlement to the age pension for the previous five years will be re-determined on the basis that the market-linked pension never had asset-test-exempt status.

If the re-assessment is that there has been an overpayment of the age pension, then the overpayment is treated as a debt due to the Commonwealth.

Given the complexity of these legacy pensions, it is essential to consult Centrelink specialist advisers before commuting a market-linked pension to determine whether the commutation will give rise to a Centrelink debt, and if so, whether there is any scope for the debt to be waived. **FS**

Notes:
1. In the case of funds that are currently on the SUPERCentral system, the new version – being version 03/25 which will apply on and from 5 March 2025 – contains the necessary powers.

The quote

Generally, market-linked pensions issued after 19 September 2007 did not have any asset-test-exempt status.