Legacy pension reforms

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Without fanfare or prior notice, the Federal Government (government) has initiated legacy pension reform. Following on from the release of draft regulations in September 2024, Treasury Laws Amendment (Legacy Retirement Product Commutations and Reserves) Regulations 2024 have been registered and are effective on and from 7 December 2024. This means that the five year commutation window has now commenced and will cease on 6 December 2029.

Legacy pension reform is about allowing individuals who currently hold lifetime pensions, life expectancy pensions and market linked pensions to exit those pensions. To use an often over used expression, legacy pensions are no longer fit for purpose and have not been fit for purpose since the reforms to superannuation that commenced 1 July 2007.

Legacy pensions are pensions which could be issued before 20 September 2007—the end date of a transition period which commenced on 1 July 2007—but could not, except for one exception, be issued after 19 September 2007. The exception relates to legacy pensions issued after 19 September 2007 from money which has been entirely sourced from the commutation payment of a legacy pension, that commenced before 20 September 2007, where the pension is either a life expectancy pension—only if the issuing fund has 50 or more members—or a market linked pension in any regulated superannuation fund including self-managed superannuation funds (SMSFs).

Legacy pension reform has two aspects: commutation reform and pension reserve reform.

These two aspects are linked. The former is concerned with permitting pensions which currently cannot be commuted, to be commuted. This reform will apply to lifetime pensions, life expectancy pensions and market linked pensions. This reform will allow a five year window in which those pensions can be commuted.

The latter is about permitting amounts, which are no longer required, to support the payment of a commuted legacy pension to be allocated to the pension recipient as an addition to their member account.

The net effect of these two reforms is that any member currently being paid a legacy pension will be able to commute that pension and the entire amount in the fund previously supporting that pension could be allocated to that member as an addition to their accumulation account.

This allocated amount will *neither* be treated as a concessional contribution nor as a non-concessional contribution. The member will then be able to either cash out that allocated amount—which will be tax-free, if the member is aged 60 or more, be used to commence an account-based pension where transfer balance cap space permits or retained in the fund as an accumulation balance.

What about legacy pensions which have special asset test treatment?

One reason to commence a legacy pension was that such pensions were entitled to special asset test treatment. A legacy pension could have either a 100% asset test exempt status— where the capital value of the legacy pension is not counted at all for the purposes of the Centrelink asset test; or a 50% asset test exempt status—where only 50% of the

capital value of the pension is counted as an asset for the purposes of the assets test. These pensions are referred to as asset test exempt pensions or ATE pensions.

While the *Social Security Act 1991* (Social Security Act) does not prohibit commutations of ATE pensions, there are adverse asset test consequences for a commutation of an ATE pension.

Under current legislation, a commutation of these income streams contrary to the conditions specified in the Social Security Act would cause the income streams to be non-ATE pensions and would trigger a retrospective reassessment of the pensioner's age pension entitlement for the previous five years on the basis that the income streams were not asset test exempt. This will, in most cases, give rise to a material overpayment of the age pension during previous five years. The position is similar for the commutation of ATE service pensions.

Legacy pension commutation

Key points of the pension commutation reform are as follows:

- To provide a five-year window to allow legacy income streams—lifetime pensions, life expectancy pensions and market-linked pensions—to be fully commuted and the commutation payment either:
  - paid to the income stream recipient as a lump sum super payment (cashed out)
  - retained in the super fund as an accumulation interest for the recipient (rolled back)
  - used (subject to transfer balance cap space) to commence an account-based pension for the recipient ('new pension').
- The commutation will give rise to a transfer balance debit equal to the amount of the commutation payment.
- If cashed out the commutation payment will be tax free (if the income stream recipient is aged 60 or more which is most likely to be the case since legacy pensions must originally have commenced before 20 September 2007).
- In the case of lifetime and life expectancy pensions – the commutation amount will usually be less than the amount in the fund which was used to support the pensions. This excess amount—the pension reserve—can be allocated to the member and will not constitute a concessional or non-concessional contribution of the member.
- If rolled back the commutation payment is treated as an internal rollover.
- If used to commence a new account based pension – the transfer balance credit arising on the commencement of the new pension will most likely be offset by the transfer balance debit arising on the commutation of the legacy pension.

When does the 5 year window commence?

The five year window commences on the day after the regulations are registered.

Must legacy pensions be commuted?

Whether the pension is commuted is entirely the choice of the pension recipient and the trustee. There is no requirement that legacy pensions be commuted.

However, every SMSF trustee currently paying a legacy pension and any SMSF member currently receiving a legacy pension should consider taking advantage of the five-year window for commutation.

What happens at the end of the five-year commutation window?

Any legacy pensions which have not then been commuted - cannot be commuted after the end of the window period.

Does the commutation window only apply if the pension is fully commuted?

Yes, the legislation explicitly states that any commutation must be a full commutation of the legacy pension.

Does the commutation window apply to legacy annuities?

The window applies to the rollover annuity equivalents of lifetime, life expectancy and market linked pensions.

Does the commutation window apply to Centrelink assets test exempt income streams?

- There is no mention of how the commutation reforms will affect ATE income streams under sections 9A (ATE lifetime); 9B (ATE life expectancy) and 9BA (ATE market linked) of the Social Security Act and the service pension equivalents under the Veterans' Entitlements Act 1986.
- These pensions will have either a 100% assets test exemption or a 50% assets test exemption.
- While the Social Security Act does not prohibit commutations of ATE pensions, there are adverse asset test consequences for a commutation of an ATE pension.
- Under current legislation a commutation of these income streams contrary to the conditions specified in those sections would cause the income streams to be non-ATE pensions and would trigger a retrospective reassessment of the pensioner's age pension entitlement for the previous five years on the basis that the income streams were not asset text exempt. This will, in most cases, give rise to a material overpayment of the age pension during previous five years. The position is similar for the commutation of ATE service pensions.
- Any change to this treatment would require changes to the Social Security Act and the corresponding provisions of the Veterans' Entitlements Act 1986 in respect of service pensions which are assets test exempt. Alternatively, any debt owing by the recipient of the commuted income stream to the government arising because of the reassessment, could be waived by a statutory instrument of the relevant Minister/Secretary.

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Can legacy pensions issued by APRA funds also be commuted?

- Market linked pension issued by APRA funds could be commuted.
- In relation to lifetime and life expectancy pensions, whether the commutation reform applies to these pensions depends entirely on whether the APRA fund which issued the pension only has income stream defined benefit interests. If the only defined benefit interests are pensions, then the commutation reform will apply to the fund.
- If the APRA fund has accumulation phase defined benefits interest, then the commutation reform will not apply to defined benefit legacy pensions issued by the fund.

Does the commutation reform apply to legacy pensions that have already ceased?

- No, as these pensions already have terminated. However, any reserves released by the prior termination of legacy pensions which remain in the fund will, however, be subject to the reserve pension reforms.
- Importantly, the reserve pension reform is not subject to a five-year window which is the case with the commutation reform.

Does the commutation reform apply to legacy pensions that have transferred to a reversionary beneficiary?

- Yes.

Pension reserve reform

Pension reserve reform deals with the treatment of amounts—called 'surplus amounts' or (released) 'pension reserves' which are no longer required to support the payment of a legacy pension because the pension has ceased, whether due to the death of the pensioner or because the pension has been commuted—under the proposed commutation reforms.

When a legacy pension ceases due to the death of the member, assuming the pension is not reversionary, the amount previously supporting the pension—the 'surplus amount'—is now available to the trustee and can be allocated by the trustee to member accounts.

When a legacy pension is commuted under the proposed changes, the member will be entitled to receive the commutation amount—which will be an actuarially determined amount—that will, in general, be less than the amount which was previously supporting the pension. This surplus amount will now be available to the trustee and can be allocated by the trustee to member accounts.

The pension reserve reforms will apply to lifetime, life expectancy pensions and flexi-pensions. Flexi-pensions are lifetime pensions which can be commuted. However, the maximum commutation value is limited by the SIS Regulations. The pension commutation reforms do not apply to flexi-pensions as they are currently already commutable. The commutation of flexi-pensions will generally give rise to a surplus amount, as the commutation amount is generally less than the pension account balance, which is then 'trapped' within the fund.

The surplus amount being 'trapped' in the fund in the sense that the surplus amount is not, under current rules, readily or easily allocated to the members without incurring significant tax liabilities.

The issue of 'trapped' reserves does not arise in respect of market linked pensions. These pensions are account style pensions. They are payable for a fixed period of years albeit the fixed period is related to the life expectancy of the member or, if the pension is reversionary, possibly the life expectancy of the reversionary beneficiary.

Market linked pensions terminate either by account-exhaustion, death of the recipient or expiration of the specified term. In the first situation, the account-balance of the pension has declined to zero. In the two other situations, there could be a balance remaining. The current rules applying to market linked pensions requires the balance of the pension account to be paid out within 28 days and that payment is treated as a death benefit of the deceased pensioner.

Current treatment of surplus amounts

On the commutation of a lifetime, life expectancy or a flexi-pension by the member receiving the pension – the portion of the fund previously supporting that pension which is in excess of the commutation value of the pension, is no longer be required for that purpose and will become a 'surplus amount' in respect of that member.

The surplus pension amount is not automatically part of the member benefit. The trustee may allocate a surplus amount to that member, or even another member, of the fund. Once the allocation is made, the allocated amount will then become part of the member account of the member. However, this allocation will generally be treated as a concessional contribution of the member to whom the allocation has been made and consequently, the fund will incur a 15% tax liability on the allocated amount.

Additionally, the allocation will reduce the amount of the member's concessional contribution cap in the income year in which the allocation is made.

However, this treatment is subject to two exceptions: the 'replacement pension exception' and the 'fair and reasonable exception'.

Replacement pension exception

The first exception is that the allocated amount is immediately applied as the initial pension balance of a market linked pension for that member, then the allocated amount is not treated as a concessional contribution of the member. In this way a lifetime or life expectancy pension can be commuted, and the commutation value applied as the purchase price of a market linked pension. While SMSFs cannot issue a new market linked pension after 20 September 2007, an exception applies where the initial pension balance of the market linked pension is derived from the commutation value of a lifetime or life expectancy pension.

Fair and reasonable exception

The second exception is that if the surplus amount is allocated to all members of the fund on a fair and reasonable basis—that is, for every member in proportion to their then account balance in the fund—and the total amount allocated to each member in an income year does not exceed 5% of the member's account balance. If the 5% cap is breached, then the entire allocation will be treated as a concessional contribution rather than merely the excess above 5% and a tax liability of 15% will be incurred by the fund.

Proposed treatment of surplus amounts

Under the proposed treatment, allocations to member accounts from surplus amounts will be treated as non-concessional contributions of the relevant members. Consequently, a much higher contributions cap will apply—$120,000 versus $30,000 for 2024/25—and the allocated amount will not be subject to 15% tax as non-concessional

contributions are assessable contributions.

Also, the two exceptions – the 'replacement pension' exception and the 'fair and reasonable' exception – still apply, with the 'replacement pension' exception being far less stringent in its application.

Additionally, a new exception has been introduced which deals with the situation where a non-reversionary legacy pension, including flexi-pensions, has ceased by reason of the death of the pensioner and the amount is allocated to a member account of a member who is a dependant of the deceased pensioner.

Replacement pension exception

This exception will now apply with the following two beneficial changes. First, the entire amount of the surplus amount can be allocated the relevant member's account as previously only the commutation value of the pension could be allocated. Secondly, the allocated amount need not be used as the initial balance of a replacement pension in the form of a market linked pension.

The allocated amount could remain in accumulation phase, be cashed out tax free as the member has most likely already attained age 60 or be used to commence an account-based pension—subject to transfer balance cap space.

Fair and reasonable exception

This exception continues to apply on the same terms as before, that is an allocation to all members in proportion to their member account balances and the allocation must be less than 5% of the relevant members' account balance.

However, now the allocation will now be treated as a non-concessional contribution rather than a concessional contribution.

Death benefit exemption

The new exception applies where the lifetime, life expectancy or flexi-pension has been commuted by reason of the death of the member to whom the pension was paid and the surplus amount is allocated to one or more member accounts of the dependants of the deceased member and then that allocated amount is paid out as a superannuation death benefit which is in the form of a superannuation lump sum.

The result of the new exception is that the surplus amount is allocated to a dependant of the deceased member and the allocated amount will not be counted as a non-concessional contribution. The allocated amount must then be paid out as a lump sum death benefit which will be tax free if the member is a death benefits dependant of the deceased but taxable at 15% if the member is a non-death benefits dependant of the deceased member.

There is no requirement for this exception to apply on a 'fair and reasonable' basis. Consequently, the trustee could choose to allocate the surplus pension amount to one or more of the dependants of the deceased member to the exclusion of the other or others not chosen. Further, there is no requirement that the allocation must be equal in amount.

For the purposes of this exception, the executor/legal personal representative of the estate of the deceased member is not a dependant of the deceased member.

Key points of reserve pension reform

- The reserve pension reforms are *not* subject to a 5-year window.
- The reserve pension reforms apply to legacy pensions which ceased before the commencement of the 5 year commutation window, during that window within the 5-year commutation window period or after the end of the 5-year commutation window period.
- The reserve pension reforms apply to flexi-pensions.
- The reserve pension reforms do not apply to market linked pensions (as these pensions do not have a pension reserve supporting them).
- The pension reserve reforms apply to legacy pensions which have previously terminated by way of death of the member or expiration of the payment period before the start of the reforms – so long as part of the pension surplus amount remains in the fund.
- The regulations simplify and improve the tax treatment of allocations of surplus amounts as follows:
  - allocations from surplus amounts arising from the commutation of lifetime or life expectancy pension – allocations to the pension recipient – are neither counted as a concessional nor as a non-concessional contribution of the pension recipient
  - allocations from surplus amounts arising from the commutation of lifetime or life expectancy pension – allocations to another member (that is not the pension recipient) are neither counted as a concessional or non-concessional contribution so long as allocation satisfies the 'fair and reasonable/5% rule'
  - allocations from non-pension reserves – are neither counted as a concessional or non-concessional contribution so long as the allocation satisfies the 'fair and reasonable'/5% rule. **FS**

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