Heffron

The Ins and Outs of SMSF Pensions in 2023/24

A guide to pensions for fund members

Superannuation is ultimately about saving for retirement. But even once you retire, you don't have to take all your money out of super.

In fact, often the best way to manage it in the long term, is to leave your super savings exactly where they are but turn some or all of them into a "superannuation income stream" or "pension" within your SMSF.

Let's walk through some of the ins and outs of pensions in an SMSF to explain why.

What exactly is a pension from an SMSF?

A pension is just a way of drawing down your super over time. It's not a special product or investment.

The super laws don't allow you to start a pension until you meet some conditions (and these are mostly to do with your age and whether or not you've retired – more on this below). But once you meet those conditions you can normally kick off a pension any time you like.

When you start a pension, all you're really doing is committing to take a minimum amount out of your fund each year. In contrast, people who just take money out of super without starting a pension are said to be taking "lump sums".

We often talk about doing this by setting up a "pension account" (and we'll use that term in this guide) but there's actually no need to invest the money separately or move it to another fund. That's sometimes necessary in public funds but not in an SMSF. (It's one of the great things about having an SMSF.)

When we talk about a "pension account" in an SMSF we're really talking about extra records your accountant will keep behind the scenes that track how much you initially decide you want to turn into a pension, how much you take out each year and a share of the fund's investment earnings that relate to your "pension account".

Any money you didn't put into a pension plus any new contributions you put into the fund (with earnings) will be recorded separately in an "accumulation account". If you have more than one member in your SMSF, you're probably already used to seeing separate "accounts" for each of the fund's members on your financial statements each year. Pensions work the same way – having both a pension account and an accumulation account is just like having two members of your SMSF.

You can have as many pensions as you like and each one will have its own "pension account" recorded behind the scenes.

It's rare but sometimes the rules specific to your fund (for example, in your trust deed) have some extra hoops to jump through. So it's important you or your accountant or adviser always check these before starting pensions from your SMSF. But for the rest of this guide, we'll just talk about what happens in most cases – ie where there are no special rules.

When can I start my pension?

Anyone can start a pension once they reach a specific age known as their "preservation age" and this is different depending on when you were born. For example, preservation age is 60 for anyone born on or after 1 July 1964 and 55 for anyone born before 1 July 1960. For those born in between, preservation age is somewhere between 56 to 59.

Importantly you don't have to be retired to start a pension – just reaching your preservation age is enough .

But if you do start a pension before you retire or turn 65, your pension will be a type known as a "Transition to Retirement Income Stream" (TRIS) that has some special restrictions.

Importantly, these restrictions generally only apply until you retire or turn 65. Then your TRIS will become what's known as a "retirement phase" pension. These are the best ones – no restrictions and some great tax benefits. Fortunately everyone gets there eventually – either because they don't start a pension until after they've retired or turned 65 and it's a retirement phase pension from the start, or they start a TRIS first and it eventually turns into a retirement phase pension.

Some people, who satisfy other specific conditions, for example, permanent disability or a terminal medical condition can also commence a pension if they want to, regardless of their age.

Some pensions we're not talking about here

You might have heard some of these names for pensions: market linked, term allocated, lifetime complying, life expectancy, flexi pensions. They are old style pensions that are very rare in SMSFs these days. In fact, you can't have any of them in an SMSF unless you've had one for some time and you'll know if this applies to you. While a lot of the things in this guide also apply to those pensions, you should definitely check with your adviser or accountant before assuming they do.

You can also receive a pension from someone else's super when they die – in most cases this would only be your spouse. We're not talking about those rules in this guide either as there are some special quirks to be aware of.

What does it mean to "retire"?

So, back to the pensions we are talking about: if you're under 65, whether or not you've retired matters. If you're over 65 it doesn't – your pension will be a retirement phase pension regardless of your work situation.

Retirement has a very specific meaning in super law. To be retired you need to have:

Ended a paying job (or wound up a business you were running in your own name) after turning 60.

If you retire under this definition, all the super you have at the time is completely accessible to you and can be turned into a retirement phase pension rather than a TRIS. However, any super you build up afterwards (new money you or an employer puts in, earnings on all of your super) is still classified as "preserved". That means it's locked up just as if you hadn't retired. If that money is turned into a pension, the pension will be a TRIS.

Example

Harvey left his full time job at age 62. This means he met the definition of retirement and all his super became completely accessible. Harvey started a pension at that time, and it was a retirement phase pension.

After he started his pension, some extra contributions were made to super by Harvey and by his new employer. These contributions (and earnings on them) are preserved. If Harvey started a new pension from his new contributions (and the earnings on them), this pension would be a TRIS.

Harvey would have 2 "pension accounts" in his SMSF and his accountant would keep track of how much is in each account. Slightly different rules would apply to each account.

OR

Reached your preservation age, ended a paying job (or wound up a business you were running in your own name) at some time in the past and decided that you never intend to work (paid) 10 or more hours per week again.

This is often called "permanent retirement" because it's a definition you can meet for good. All your super is fully accessible to you, even new money you put in and future earnings on all your super. Any pensions you start will be retirement phase pensions.

The only thing that can change this is if you change your mind before age 65 about getting another job / starting another business. If you do, new money and earnings after that time will be preserved. Only the super you built up beforehand will stay "unpreserved".

Example

Janine (59) recently decided she was never going to work (paid) 10 or more hours per week again.

This means she met the definition of retirement and all her super at that time became completely accessible.

A while later, Janine made some extra contributions to her super. These contributions and any earnings on both her earlier super balance and her new contributions would also be unpreserved (and could be used to start a retirement phase pension) as long as she hadn't changed her mind about working.

Why are pensions so good and why do people love them?

For a start, pensions are one way of accessing your super and giving you money to live on when you retire. This is, after all, the purpose of super in the first place. In fact, if you're not retired or 65, a TRIS is generally your only option when it comes to accessing your super. You're generally not allowed to take a lump sum.

Little or no personal income tax

But even better, the tax treatment on the pension payments you receive from your pension account is very good.

They are completely tax free after you turn 60 and even before 60 (between your preservation age and your 60th birthday) there are some valuable tax breaks – some of your pension payments might not be taxed at all and the bit that is taxed gets a tax offset of 15%. (It's a bit like getting special tax rates that are 15% lower than the ones you pay on any other income like a salary, rent, dividends etc).

This great tax treatment applies to all pension payments – regardless of whether they're from a TRIS or a retirement phase pension.

So someone who is 60 would much prefer to receive (say) $50,000 per year from their super pension account which is tax free, than $50,000 per year in income from their personal investments like rent, interest or dividends which is taxed.

Stellar tax breaks for your SMSF

Even better, there's a special tax rule for SMSFs paying retirement phase pensions (not a TRIS unfortunately – until it turns into a retirement phase pension).

When your SMSF is paying a retirement phase pension, some or all of the SMSF's investment income is completely tax free too.

For example, if all of the super in your SMSF has been moved over to a retirement phase pension account, then the SMSF pays no tax on its investment income at all. That includes capital gains that might have built up over many years, including before your pension started.

Example

For example, the assets in Stella's SMSF have been building up over the years and during 2023/24 her fund received $35,000 in fully franked dividends (these came with a $15,000 franking credit), $10,000 in interest and her SMSF also sold some shares that it owned for over 10 years and made a great capital gain ($100,000).

Stella has retired. She turned all the super in her SMSF into a retirement phase pension account on 1 July 2023 and hasn't put any new money in since. Stella's SMSF will pay no tax on this income and will in fact just get a refund of the $15,000 franking credits. The fund even pays zero tax on the capital gains from the shares that had been building up over many years – mostly before she even started her pension.

It's this benefit that actually makes pensions incredibly attractive.

Stella, for example, could have a large share portfolio and property in her SMSF. Her fund pays no tax on its dividends and rent and neither does she when she receives her pension payments.

If Stella's super had gone into a TRIS rather than a retirement phase pension, her fund wouldn't see any change in its existing tax treatment. All the same rules she's had in the past would continue. But these aren't too bad either – remember that super funds only pay tax at 15% which might be much less than you'd pay if you held the same assets personally and paid tax on them in your own name.

If Stella's fund had a mixture of retirement phase pensions and other accounts (like a TRIS and an accumulation account), the tax treatment would be a combination of the two. Very broadly, if only half her fund was in a retirement phase pension all year then only half of its investment income would be tax free.

Sounds great – can I put all my super into a pension?

Unfortunately there is a limit on the amount you can put into a retirement phase pension. If you've never had a retirement phase pension before this limit is currently $1.9m. If you have, it will be somewhere between $1.6m and $1.9m.

There is no limit on the amount you can put into a TRIS.

That might sound odd – doesn't it mean a TRIS is better? Not really, because remember a TRIS doesn't get all the great tax breaks that apply to retirement phase pensions. A fund that is paying a TRIS rather than a retirement phase pension will still pay tax on its investment income.

How does my TRIS become a retirement phase pension?

When you retire or turn 65. If you retire, you need to formally document that you've told the trustee of your SMSF that you've done so. It's only then that your TRIS will become a retirement phase pension.

At that point, your pension will be checked against the $1.6m – $1.9m limit. If it's over the limit you'll have to take some extra money out of your pension. It's called a commutation and it doesn't have to be paid out of your fund entirely, it just has to be taken out of your pension (it can go back into your accumulation account).

And then your SMSF starts getting the great tax break explained earlier for Stella.

If you start your pension in the middle of the year rather than 1 July, that tax treatment will only apply to some of your fund's income – talk to your accountant or adviser to get the specifics in your case.

What about the money I don't put into a pension?

That's OK – it can just stay in your fund and enjoy the usual (great) tax treatment for super funds. Once you're allowed to fully access your super (for example, you're over 65 or have reached your preservation age and retired), you can take it out of super if you want to. Most people don't as they find the tax treatment is better in super.

Pension payments

If you start a pension you have to commit to taking a minimum amount out of your pension account each year. How does that work?

Well firstly, you don't have to commit to taking regular amounts or even deciding in advance how much you will take in a particular year. You just have to make sure you take at least the minimum payment requirement over the year. Some people take this all at once just before the end of the financial year if they don't need the money regularly.

The minimum you have to take is based on your pension account balance and your age at the start of each year (or the day you start your pension in the first year). The table below shows a percentage applicable for each age.

If the percentage, based on your age is 5% and your pension account balance is $500,000 at the start of the year, the amount you must take during the year is:

5% x $500,000 = $25,000 (rounded to the nearer $10)

If you start your pension in the middle of the year, the amount is adjusted to reflect that – for example, if you started your pension half way through the year, the minimum payment would be roughly half the normal amount.

The percentages for each age are:

	2023/24 & onwards
Under 65	4%
65-74	5%
75-79	6%
80-84	7%
85-89	9%
90-94	11%
95 +	14%

That's the minimum you have to take.

If you have a retirement phase pension, there's no upper limit – you could take the whole balance out in a single year if you really wanted to.

If you have a TRIS, there's also an upper limit. It's 10% of your pension account balance at the time of the calculation. So if your pension has been in place for a while and you're calculating the current year's maximum payments, it's 10% of your TRIS account balance at the start of the year. If you're just starting your TRIS, it's 10% of the account balance when the TRIS starts (even if this is right at the end of the year).

Regardless of how much you take, pension payments have to be paid to you in cash – they can't be paid by transferring some of the fund's assets (like shares or managed funds) to you.

Managing the cash flow

It's when it comes to managing the cash flow that SMSF pensions really come into their own.

Firstly, it's important to know that in an SMSF you don't have to isolate pension accounts from (say) accumulation accounts in any way and that can be really useful.

Example

Terry and Clare are both 70 but still working. They started their retirement phase pensions a few years ago when the limit was $1.6m and used this limit in full. They had an extra $100,000 (each) in super at the time which stayed in their accumulation account. Since then, the super contributions made by their employers have also gone into their accumulation accounts.

Each year the contributions from their employer as well as dividends, rent, interest etc from their SMSF's investments go into their fund's bank account. They use this cash flow to pay their pension payments. Notice how they didn't need to keep their contributions separate to the income from their pension accounts? Their accountant will be keeping a running tally in the background but when it comes to the practicalities of making pension payments, they are absolutely fine to mix the two and use cash flow from contributions to make pension payments.

Terry and Clare don't have to make their pension payments separately – they can take amounts out regularly or just when they feel like it, and decide how to split it between them for accounting purposes but bank the whole lot into a single personal bank account.

A lot of large funds (non SMSFs) don't allow this. They force each member to have their own investments in the super fund and make their pension payments from "their" investments while the contribution money coming in is invested separately. It can mean they are selling investments (to pay pension payments) on the one hand but buying new investments (with the contribution cash flow) on the other.

Some non SMSFs even insist that the pension payments are banked into an account in the member's own name. That could be inconvenient for Terry and Clare if it so happens that they want (say) all their pension payments to go into an account that is just in Clare's name. SMSFs are different – they don't have these extra rules.

Note that some people decide to set aside specific assets for their pension accounts. And that's OK too – SMSFs are incredibly flexible. If you do this, it's worth getting advice from your accountant or adviser on how that will impact things like:

- Structuring your cash flows – generally it means that you need to be more particular about taking pension payments from the right bank account and not using contribution cash flow to pay pension payments.
- The tax treatment of the fund – generally it means that only the assets specifically set aside to support the pension account get the great tax treatment outlined earlier.

Is starting a pension a "forever" decision?

No. You can stop an SMSF pension at any time. If you have full access to your super at the time you stop your pension, you can withdraw it all from your fund. If you don't have full access or you want to leave it in super but stop your pension, you can do that too – it's often called "rolling back" to accumulation phase. It just means your pension account will get put back into your accumulation account.

You might need to take a pension payment first depending on how much you've already taken out that year – your accountant or adviser will be able to help you work that out.

If my retirement phase pension balance goes over my $1.6m – $1.9m limit do I have to take some money out?

No. The limit is only checked when the pension starts. It can grow afterwards and that's fine.

Why would I have more than one pension account?

When a pension starts, you can't add any more money to it. So if you put more money into super later (e.g. you or your employer make contributions), you might want to start a pension with that money and the most common approach is to start a new, separate pension.

Example

For example, Jessie permanently retired a few years ago when she was 60 and started a pension with all her super ($1m). She then put some more contributions in over the next few years and now wants those monies to go into a pension account too. She could do one of two things.

Firstly, she could just start a new (second) pension with this additional money. If she does, she'll have two pension accounts in the fund and will have to pay the minimum amount every year from both of them. It will be calculated separately but she doesn't have to actually draw separate payments from each one – it's just like Terry and Clare's situation earlier, she can decide how she splits a single payment between her two pensions.

Alternatively, she could stop her existing pension, combine it with her new contributions and then start a new (single) pension. Then she'd only have one pension account.

That might sound simpler but often it's not. For a start, it will mean she has to make sure she's paid "enough" from her existing pension to be allowed to stop it. (For example, if she's stopping it half way through the year, she'll have to pay roughly half the normal minimum amount before she can stop her pension.)

Then she'll have to recalculate the amount she needs to pay for the rest of the year from her combined (new) pension.

Stopping her old pension might also disrupt some handy benefits she's entitled to. For example, if her old pension started before 1 January 2015, it's completely ignored when it comes to working out her income for the Commonwealth Seniors Health Card. Only her new pension account will count when it comes to assessing her income for that Card. But if she stops her old pension and starts a combined (new) one, the combined pension account will count. It definitely makes sense to check with your accountant or adviser before switching off any old pensions.

Having more than one pension account can also give you some extra flexibility when it comes to organising your pension payments.

You have to take the minimum amount from all your pensions every year. But what if you take more than the minimum? You can choose which pension(s) that's paid from. Sometimes there are good reasons to take extra payments from a particular pension.

For example, when pensions start your accountant will work out what proportion of that pension is considered to be a "taxable component" and how much of it is a "tax free component". While this won't be relevant for **you** once you turn 60, it could be highly relevant to anyone who inherits your super when you die. Mostly, anyone other than your spouse or minor children pay tax on the "taxable component". So it makes sense to use up any pensions with a high taxable component first, leaving as little as possible behind when you die. Unfortunately when you take a payment from a pension you can't choose to only draw down on its taxable component – your payment will automatically be divided between your taxable and tax free components for that particular pension.

But you can choose which pension you take your payment from. If one pension has a higher taxable component than another, you could take any extra payments from that one.

And it's common for different pensions to have different taxable components. Take Jessie (above) for example. The $1m pension she started a few years ago was all the super she'd built up over her working life and it was probably mostly a taxable component. Since then, if a lot of the money that's gone in as contributions has come from her own personal savings and she didn't claim a tax deduction for any of it, a lot of it will be a tax free component. Starting a new, separate pension with that amount might be far better for her beneficiaries than combining it with her existing pension.

What happens to my pension(s) when I die?

That depends on how you set them up.

If you set them up to continue automatically to, say, your spouse then that's what will happen when you die. Your spouse will inherit your pension account and the pension payments will keep going. Your spouse might need to make some changes to their own pension, particularly if they have already used up a lot of their own $1.6m–$1.9m limit. They will also be able to withdraw all your pension account (ie take the money out of the fund) if they want to. They should get advice on this.

If you didn't set your pension up this way, it will stop when you die. A very small number of people (generally your spouse and minor children) can use the money to start a pension back up again but others (say adult children) will have no choice but to withdraw the money out of super.

This all sounds great, how do I do it?

Starting a pension is actually really easy in an SMSF. As the member, you need to formally request (generally in writing) that the trustee starts your pension and how much should go into it (all of your balance? just some?). You need to specify whether you want it to continue to your spouse when you die, and if you wanted to set aside specific assets to support it or whether you're happy with the more normal approach of just keeping all the fund's assets mixed together.

The trustee then needs to agree to your request and then your pension is underway.

The decision has to be made before the pension starts even if the documentation doesn't happen until shortly afterwards.

If your pension is a retirement phase pension, the trustee will need to tell the ATO about it – because they need to keep track of how much of your $1.6m–$1.9m pension cap you've used.

You can decide how much you draw in pension payments any time – as long as you take the required minimum before the end of the year.

Conclusion

Pensions in SMSFs are one of the most powerful retirement planning structures around. It's almost inevitable that if you have an SMSF you will have a pension one day – and once you retire or turn 65, often the sooner the better.

Disclaimer

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Get in touch today

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