

What is a reversionary pension?

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There is a little known rule that can have huge implications for SMSFs, particularly when it comes to reversionary pensions.

This article provides the crucial 'must know' details.



What is a 'reversionary pension'?

The ATO describes a reversionary pension as follows, without actually using the term 'reversionary' (Taxation Ruling TR 2013/5 [29]):

A superannuation income stream ceases as soon as a member in receipt of the superannuation income stream dies, unless a dependant beneficiary of the deceased member is automatically entitled, under the governing rules of the superannuation fund or the rules of the superannuation income stream, to receive an income stream on the death of the member. If a dependant beneficiary of the deceased member is automatically entitled to receive the income stream upon the member's death, the superannuation income stream continues

They also describe it as follows (Law Companion Ruling LCR 2017/3 [12]):

A reversionary death benefit income stream is a superannuation income stream that reverts to the reversionary beneficiary automatically upon the member's death. That is, the superannuation income stream continues with the entitlement to it passing from one person (the member) to another (the dependant beneficiary).

The income tax legislation uses the term 'reversionary beneficiary' (see item 1 in the table in s 294-25(1) of the ITAA 1997). Although the income tax legislation does not define the term, the explanatory memorandum that introduced this legislation does state that a 'Reversionary income stream' means (Explanatory Memorandum, Treasury Laws Amendment (Fair and Sustainable Superannuation) Bill 2016 (Cth) 7):

A superannuation income stream that automatically reverts to a nominated beneficiary on the death of its current recipient.

The common theme in all of the above definitions is the idea that the pension continues to be paid upon death *automatically* (ie, that the SMSF trustee is instantly bound and compelled to continue paying the pension).

Case study

Imagine an SMSF trustee that signs a pension agreement with a member stating that the trustee will start paying a pension to the member now and that later when the member dies, the pension will automatically continue to be paid (ie, revert) to the member's spouse. The trustee makes resolutions confirming this.

Most would think that this agreement is binding, and that once the member dies the trustee is compelled to pay the pension to their spouse.

However, there is more to the picture!

The rule against 'fettering'

There is a general rule against trustees of trusts — which includes SMSF trustees — fettering their discretion.

The specifics of this rule were conveniently summarised by Chesterman J in *Dagenmont Pty Ltd v Lugton* [2007] QSC 272:

According to the *Law of Trusts* by Underhill and Hayton 16th edition (p 690):

... it is trite law that trustees cannot fetter the future exercise of powers vested in trustees ex officio Any fetter is of no effect. Trustees need to be properly informed of all relevant matters at the time they come to exercise their relevant power.'

Meagher and Gummow in *Jacobs Law of Trusts in Australia* 6th edition para 1616 say:

Trustees must exercise powers according to circumstances as they exist at the time. They must not anticipate the arrival of the proper period by ... undertaking beforehand as to the mode in which the power will be exercised *in futuro*.

Professor Finn (as his Honour then was) in his work *Fiduciary Obligations* wrote (at para 51):

Equity's rule is that a fiduciary cannot effectively bind himself as to the manner in which he will exercise a discretion in the future. He cannot by some antecedent resolution, or by contract with ... or a beneficiary — impose a 'fetter' on his discretions.

Finkelstein J summarised the position succinctly in *Fitzwood Pty Ltd v Unique Goal Pty Ltd (in liq)* [2001] FCA 1628 (para 121). His Honour said:

Speaking generally, a trustee is not entitled to fetter the exercise of discretionary power (for example a power of sale) in advance. If the trustee makes a resolution to that effect, it will be unenforceable, and if the trustee enters into an agreement to that effect, the agreement will not be enforced ...

In short, if a trustee has a discretionary power and the trustee decides now how it will exercise that power in the future, such a decision will be unenforceable.

This is extremely relevant in the context of reversionary pensions.

Tax issues

The ATO applies a strict test on when a pension ceases upon the death of a member a pension ceases unless it is automatically reversionary. As noted in TR 2013/5 at [29] above, a pension ceases '*unless a dependant beneficiary of the deceased member is automatically entitled*'. The following paragraph of TR 2013/5 is key to understanding what the ATO consider to be an automatically reversionary pension:

126. A superannuation income stream automatically transfers to a dependant beneficiary on the death of a member if the governing rules of the superannuation fund, or other rules governing the superannuation income stream, specify that this will occur. The rules must specify both the person to whom the benefit will become payable and that it will be paid in the form of a superannuation income stream. The rules may also specify a class of person (for example, spouse) to whom the benefit will become payable. It is not sufficient that a superannuation income stream becomes payable to a beneficiary of a deceased member only because of a discretion (or power) granted to the trustee by the governing rules of the superannuation fund. The discretion (or power) may relate to determining either who will receive the deceased member's benefits, or the form in which the benefits will be payable.

How this applies to pensions

The vast majority of SMSF deeds provide that if upon death there is no binding death benefit nomination ('BDBN'), then the trustee has a discretion regarding to whom (eg, to spouse) and how (eg, as a pension) any death benefit is paid.

Accordingly, if the trustee has previously:

- resolved; and/or
- agreed;

how this discretionary power will be exercised in the future (eg, that the pension revert to a spouse), this constitutes a fetter and will not be enforceable!

When is this practically most a problem?

In a practical sense, if upon death the trustee wants to pay a pension to the person named reversionary beneficiary in the pension documents, it is unlikely to cause any practical problems. However, in that circumstance it was unlikely that a reversionary pension was needed in the first place. (That is, if there's a trustworthy person running the SMSF there's no great need to restrict their actions — unless there is some particular social security law or tax reason resulting in an automatically reversionary pension being desirable.)

However, consider the situation where the trustee of the SMSF does not want to pay the death benefit to the surviving spouse. It could be that the spouse is the member's second spouse and the member has children from a prior relationship who are on adverse terms.

Subject to how the member's will, SMSF deed and related documents are drafted, it is possible that the children from the prior relationship will end up as SMSF trustees after the member's death. Assume that the children from the prior relationship no longer get on with their (now former) step parent.

Accordingly, the children might point to the rule against fettering discretion and say that any pension documents are invalid and that it would be wrong of them to blindly follow the reversion in those pension documents. Accordingly, they might choose to remake the decision as to who to pay death benefits to. Somewhat unsurprisingly, in these circumstances children tend to pay the benefits to themselves; self-interest generally wins out.

Although there are some grounds on which the children's action could be challenged by the spouse, the spouse would be facing an uphill legal battle.

Can a fetter ever be valid?

It is possible for a fetter to be valid. After all, a BDBN is really just a type of fetter.

However, in order for such a fetter to be valid, the deed must allow for it. As Harman LJ stated in *Muir v Inland Revenue Commissioners* [1966] 1 WLR 1269, 1283 'if a power is conferred on trustees *virtute officii*, that is to say, if it is a trust power which the trustees have a duty to exercise, they cannot release [eg, enter into a fetter] it *in the absence of words in the trust deed authorising them so to do*' (emphasis in the original).

Unfortunately, few SMSF deeds are written with clear enough provisions to successfully oust the prohibition on fettering. Naturally, DBA Lawyers' SMSF deed is appropriately drafted in this regard.

Different types of reversionary pensions

Thus, there two main types of reversionary pensions, namely:

A discretionary reversionary pension where there is no valid fetter in the SMSF deed that 'locks in' the nomination of the reversionary beneficiary.

There is an enforceable automatically reversionary pension supported by an SMSF that includes a valid fetter that satisfies the ATO's criteria in TR 2013/5.

There are numerous SMSF deeds that provide a priority to a reversionary pension nomination over a BDBN in the event of conflict, eg, if the member's pension nominates the surviving spouse but the BDBN nominates their estate (legal personal representative), then the pension nomination wins out.

One of the risks of relying on this type of SMSF deed is that, as explained in this article, the pension documents themselves may not provide a binding pension nomination. Thus, the priority given to the pension nomination could itself be subject to challenge resulting in the BDBN taking priority. (Note, we have covered a number of other issues of this type of SMSF deed in our recent articles -- refer to related articles below.)

We therefore recommend that members seeking to rely on a reversionary pension nomination priority obtain confirmation that their pension nominations are valid and effective if they also have made a BDBN. Moreover, such members should also obtain confirmation that their BDBNs are valid and effective as the reversionary nomination may undermine what is in their BDBN.

Advisers also need to be aware when assisting clients in relation to these when they may overstep the line and they start to provide legal services. Advisers are best to ensure the client's lawyer reviews and settles these documents so they are consistent with the client's wills and estate plans.

After many years of practical experience and having assisted many clients in legal disputes and cases, DBA Lawyers' generally recommends that an SMSF deed should provide clear priority to the BDBN. There should also be a conflict clause that provides certainty on what wins out in the event there is a conflict between a reversionary pension nomination and a BDBN. Unfortunately, many SMSF deeds leave these matters 'ripe' for disputes to easily arise.

Practical implications

There are several practicable take-aways that advisers should note.

Firstly, pension documentation alone is unlikely to implement an enforceable reversionary pension.

Secondly, if someone does want to implement an enforceable automatically reversionary pension, regard must be had to the wording of the SMSF deed, any BDBN and other related documentation.

Thirdly, make sure the SMSF documentation used is provided by a quality supplier who has relevant experience and qualifications to ensure the documents are valid and effective (eg, will the SMSF deed and pension documents facilitate an enforceable automatically reversionary pension that satisfies the criteria in TR 2013/5?).

Finally — and most importantly — it is critical to determine who will be controlling the SMSF upon death. If someone who wishes to frustrate the wishes of the deceased is controlling the SMSF, regardless of whether there is binding and effective documentation in place, the rightfully entitled recipients might face a very difficult legal battle in obtaining what is their entitlement.

Related articles:

- [Reversionary pensions v. BBDNs: advisers' risks](#)
- [Reversionary pension v BDBN: which one wins?](#)
- [Reversionary pension vs BDBN: which outcome is preferred?](#)
- [Reconciling inconsistencies between reversionary pension nominations and BBDNs](#)
- [Automatically reversionary pensions and super reform](#)

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This article is for general information only and should not be relied upon without first seeking advice from an appropriately qualified professional.

Note: DBA Lawyers hold SMSF CPD training at venues all around Australia and online. For more details or to register, visit www.dbanetwork.com.au or call Marie on 03 9092 9400.

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