Defined Benefit Superannuation Funds

What is a Defined Benefit Superannuation Fund?

A defined benefit superannuation fund provides benefits to its members as either a lump sum or as a pension (i.e., a regular income stream), and sometimes as a combination of both, with the benefit being determined by applying a formula rather than being based on accumulated savings and investment earnings.

The formula used to determine benefits may vary between superannuation funds however it is customary for the formula to be based on factors including a member's years of membership and their salary, often being their final average salary.

A defined benefit superannuation scheme has an advantage over "market linked" schemes in that a member's interest in the fund does not fluctuate with movements in underlying investment markets. The member's benefit, being formula based, may be more predicably estimated.

By contrast, a member's interest in a defined benefit fund may not grow at the same rate as members of other types of superannuation funds, particularly when investment markets are performing well. Members with a defined benefit superannuation interest will generally not be able to select the way their account is invested.

Defined benefit superannuation funds are less common now than they used to be.

The main types of defined benefit funds available today are funds offered by States and the Commonwealth Government for public sector employers. Some private sector employers may still offer defined benefit funds for their employees. Even amongst public sector employers, many defined benefit funds are now closed to new members.

Employers that still maintain a defined benefit superannuation fund, will generally provide hybrid benefits for their employees.

That is, part of an employee's superannuation benefit may come from a defined benefit component, and part of the benefit, such as a "productivity" component and member financed benefits, may be provided in the form of the more common "accumulation" account.

Accumulation accounts are market linked, meaning a member will often have investment choice, and the value of their account will be influenced by contributions made and movements in underlying investment markets.

Benefit payment options

Once a member becomes entitled to access their defined benefit, the benefit will be calculated by the administrator of their fund.

Depending on the type of fund, the benefit will be paid as a lump sum, which can be rolled over to another superannuation fund if desired, for the purposes of commencing a retirement income stream such as an account-based pension, or the benefit may be paid as a pension for life. Not all defined benefit superannuation funds provide a defined benefit pension.

If the fund pays its benefit as a pension, the fund may offer the option for all or a part of the pension to be commuted and paid as a lump sum. Generally, the decision to commute a defined benefit pension to a lump sum will need to be made within a relatively short period once entitlement to receive the benefit arises.

The terms of a defined benefit pension will be set out in the rules of the fund however, they will generally include the following:

- The pension is payable for the life of the member,
- When a member passes away and is survived by a spouse, a "reversionary" pension (sometimes at a reduced rate) may be payable to the spouse for the remainder of their life,
- The pension payments may be indexed to keep pace with inflation,
- Once the pension commences to be paid, it can generally not be commuted to a lump sum,
- Once the member and their surviving spouse, if applicable, have passed away, the pension ceases to be paid.
- All or part of the pension payment may be counted as income when determining entitlement to the government age pension – see the section "Social Security" for more information.
- All or part of the pension payment may be taxable, depending on the nature of the superannuation fund paying the pension – see the section "Taxation" for more information.

Capped defined benefit pensions

In this Guide, reference to defined benefit pensions is restricted to capped defined benefit pensions paid from a taxed or an untaxed superannuation fund. It does not include lifetime or life expectancy annuities paid from a life insurance company, nor does it include market linked income streams (also known as term allocated pensions).

Whether to take a defined benefit as a pension?

In general terms, a defined benefit pension may suit a person with an average or above average life expectancy who is seeking a predictable income stream paid at regular intervals, for life.

In situations where a person has a poor health outlook and has a below average life expectancy, they do not have a spouse, or they require capital to meet expenses, a lump sum payment may present a more suitable option.

Whether a defined benefit pension is suitable will depend on individual circumstances. The advantages and disadvantages of receiving a defined benefit as a pension or as a lump sum should be discussed with your financial adviser.

Taxation

The taxation of lump sums and pension benefits from a defined benefit superannuation fund will depend on whether the superannuation fund is a taxed fund or an untaxed fund. Often untaxed funds may also be referred to as constitutionally protected funds or unfunded schemes.

A taxed superannuation fund pays tax on contributions and investment earnings on an ongoing basis.

By contrast, an untaxed fund does not pay tax on contributions and investment earnings. Rather, tax is deducted at the time a benefit is received from the fund or is rolled over to a taxed superannuation fund.

Benefits paid from State and Commonwealth superannuation funds may include an untaxed element.

Examples of superannuation funds likely to include an untaxed element are:

- Commonwealth Superannuation Scheme (CSS),
- Public Sector Superannuation Scheme (PSS),
- Defence Forces Retirement and Death Benefit Scheme (DFRDB), and
- Military Super.

Example of State Government schemes that may include an untaxed element include:

- West State and Gold State Super (WA),
- Triple S (SA),
- Emergency Services Superannuation Scheme (Vic).

This list is not exhaustive. Your superannuation fund will be able to tell you if your account includes a taxable component – untaxed element.

In general terms superannuation fund member benefits may include one, two, or all the following components:

1. Tax-free component – generally this includes personal contributions made by a member who has not claimed a tax deduction for the contributions.
2. Taxable component – taxed element – that portion of a member's account that comprises of contributions and investment earnings that have been taxed on an ongoing basis.
3. Taxable component – untaxed element – contributions and investment earnings accruing in an untaxed superannuation fund. The contributions and investment earnings have not been taxed on an ongoing basis.

The following tables set out the rate of tax applicable to both lump sums and pensions paid from defined benefit funds:

Lump sum benefits

Component	Age	Maximum tax rate
Tax free	Any age	Tax-free
Taxable – (taxed element)	< Preservation age	20%
	Preservation age to 59	Up to low-rate cap = 0% Above low-rate cap = 15%
	Age 60 and above	Tax free
Taxable – (untaxed element)	< Preservation age	Up to untaxed plan cap = 30% Above untaxed plan cap = 45%
	Preservation age to 59	Up to low-rate cap = $15% Between low-rate cap and untaxed plan cap = 30% Above untaxed plan cap = 45%
	Age 60 and above	Up to untaxed plan cap = 15% Above untaxed plan cap = 45%

Notes:

1. The low-Rate cap for 2021/22 is $225,000
2. The untaxed plan cap for 2021/22 is $1,615,000
3. Where tax is payable, the Medicare Levy is also payable in addition to the rates mentioned above.

Pension benefits (capped defined benefit income streams)

Component	Age	Amount below DB income cap	Amount above DB income cap
Taxed	< Preservation age	Taxed at MTR	Taxed at MTR
	Preservation age to 59, or paid due to permanent incapacity to age 59	Taxed at MTR, less 15% tax offset	Taxed at MTR, less 15% tax offset
	Age 60 and above	Tax free	50% of amount above cap taxed at MTR
Untaxed	< Preservation age	Taxed at MTR	Taxed at MTR
	Preservation age to 59	Taxed at MTR	Taxed at MTR
	Age 60 and above	Taxed at MTR, less 10% tax offset	Taxed at MTR

Notes:

1. The DB (Defined Benefit) cap for 2021/22 is $106,250
2. MTR = marginal tax rate
3. Where tax is payable, the Medicare Levy is also payable in addition to the rates mentioned above.

When a member has an interest in an untaxed fund and they seek to rollover their benefit to a taxed superannuation fund, and part of the amount rolled over is a taxable component – untaxed element, the untaxed element is taxed on rollover at a rate of 15% up to the untaxed plan cap, and 45% on any untaxed component above the untaxed plan cap.

The untaxed element is then treated as a taxed element within the new superannuation fund.

Total superannuation balance

A person's interest in a defined benefit superannuation fund is counted towards their total superannuation balance.

Generally, the amount counted for total superannuation balance purposes from a defined benefit that has not commenced being paid as a pension, is the amount that would have been available had a member voluntarily withdrawn their benefit from the fund. The total superannuation balance is calculated as at the previous 30 June and is reported to the Australian Taxation Office by superannuation funds each year.

Where a person's total superannuation balance exceeds $1,700,000, they are unable to make additional non-concessional contributions to superannuation.

A person can check their current total superannuation balance by accessing their MyGov account.

When a defined benefit pension commences to be paid, it is counted towards the person's transfer balance cap.

The amount counted against the transfer balance cap is based on the annualised income for the first year, multiplied by a factor of 16.

Where a person has superannuation in addition to their defined benefit, the amount of the defined benefit pension counted towards their transfer balance cap may restrict how much of their other superannuation can be transferred to the pension phase.

Contribution caps

Contributions to constitutionally protected funds are counted against a member's concessional contribution cap however these contributions, taken on their own, cannot result in an excess concessional contribution. However, they may affect a member's ability to make concessional contributions to other (taxed) superannuation funds.

Social security

As a defined benefit pension does not have a capital value (once the pension commences to be paid) it is not assessed under the assets test for Centrelink and Department of Veterans Affairs purposes.

The income received from a superannuation pension is assessable under the income test.

Where the income includes a tax-free component and a deductible amount applies, the income assessed under the income test is the annual income, less the deductible amount.

Since 1 January 2016, the deductible amount has been capped at a maximum of 10% of the income received. However, the 10% cap does not apply to pensions paid from the following schemes:

- Defence Force Retirement and Death Benefits Scheme (DFRDB),
- Military Superannuation and Benefits Scheme (Military Super), and
- Defence Force Retirement Benefits Scheme (DFRB)

Unique Features

Defined benefit superannuation is a complex topic.

While many defined benefit superannuation funds have general similarities with each other, they can vary significantly when it comes to their specific features.

This Guide considered defined benefit superannuation funds at a high-level.

Members of defined benefit superannuation funds should seek to understand how their specific fund operates in terms of when benefits become payable, the payment options available, and whether the fund is a taxed fund, an untaxed fund, or a combination of both.

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