SISFA

SMALL INDEPENDENT SUPERANNUATION FUNDS ASSOCIATION

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By e-mail to: **superannuation@treasury.gov.au**

Dear Sir or Madam

Review of the provision of pensions in small superannuation funds

SISFA welcomes the opportunity to contribute to the Treasury's initial round of consultation in relation to the above review.

Introduction

We commend the Government for acting to quash the use of any superannuation scheme for tax avoidance or other non-retirement income related purposes. SISFA is and will always be a proponent of such actions and we have been advocating for some time now that steps need to be taken to achieve higher standards of compliance in the small fund market. As such, we would typically support any measures that seek to deal with the aggressive promotion or use of reserving, forfeiture and estate planning strategies in small superannuation funds.

However, we believe that the recently released Superannuation Industry (Supervision) Amendment Regulations 2004 (No 2) ("***the regulations***"), which purport to address such strategies, are poorly targeted with grossly unjust consequences, particularly in relation to defined benefit pensions. It is our view that to the extent that such avoidance strategies are being used in practice, they can be addressed quite simply with minor amendments to the Tax Act and the review and tightening of actuarial standards. There is no need to deny small superannuation funds the ability to pay the same retirement income streams available to members of larger funds.

We are aware that the Government Actuary has expressed concerns that defined benefit arrangements in small superannuation funds have been used for certain tax avoidance or non-superannuation purposes and there has been a consequential cost to revenue. We are unable to provide any evidence to suggest that the use of so-called defined benefit arrangements has resulted or would ever result in any quantifiable cost to revenue. We also note that no such evidence was forthcoming during the recent Senate Estimate Hearings or in the inquiry conducted by the Senate Legislation Committee. ***Accordingly, we are of the view that in the***

continuing absence of supporting empirical evidence, the regulations have little, if any, justification in relation to defined benefit arrangements.

Importantly, recent changes to the *Social Security Act* mean that from 20 September 2004, the 100% exemption from the asset test for these retirement income streams has been reduced to a 50% exemption.

We also consider that some of the strategies referred to above may have already been ineffective under the law prior to these changes (see for example ATO Interpretative Decision ID 2001/158 and the recent Federal Court decision in *Walstern v Deputy Commissioner of Taxation*).

It must also be said that the drafting of the regulations has of itself caused complications, confusion and possibly unintended consequences. This is particularly apparent, for example, in relation to the attempt to grandfather certain defined benefit pension arrangements, which we believe may not be effective due to the operation of the definition of "defined benefit fund" in the Superannuation Industry (Supervision) Regulations 1994. Another example involves the regulators' very strict interpretation of what may constitute an amendment to a fund's governing rules, also in the context of grandfathering defined benefit pension arrangements. This interpretation (outlined in detail in draft Superannuation Determination SGD 2004/D1) would appear to be inconsistent with that adopted by many practitioners and trustees in the market place, and so the potential for confusion is high.

The recently introduced amending regulations to allow the commencement of defined benefit pensions up to 30 June 2005 are also not without their problems. There are a number of anomalies in these regulations. For example, the regulations allow defined benefit pensions to be paid in certain circumstances where:

- a person was a member of a fund on 11 May 2004;
- before 1 July 2005, the person attains age 65 or retires on or attaining age 55;
- the person becomes entitled to be paid a defined benefit pension after 11 May 2004 and before 1 July 2005; and
- the first pension is paid within 12 months of the person becoming entitled to it.

It is not clear what the position is, of a person who retired on (say) 5 May 2004 and became entitled to a defined benefit pension on that date but had not commenced it on 11 May 2004. On a technical interpretation of the regulations, that person would not be permitted to be paid a defined benefit pension despite the fact that his or her entitlement arose prior to the budget announcements. This uncertainty is causing enormous problems for advisers in the industry.

We appreciate that these issues may be outside the scope of this review, but such examples (and there are others) simply highlight that there are preferred approaches to handling the problems, actual or perceived, that the regulations have sought to address.

SISFA's Preferred Approach

We believe that the modified approach set out below will address the Government's concerns as well as alleviating the problems associated with the transitional arrangements and grandfathering provisions.

Reasonable Benefit Limit (RBL) Concerns and Defined Benefit Pensions

We are aware that one of the areas of concern that this review is considering is the use of lifetime pensions to access large amounts of superannuation benefits and still be within the RBL system (so-called "RBL compression").

In this regard, however, we are struggling to understand the real mischief that the regulations are addressing. If it is indeed "RBL compression", then we submit that the measures do nothing to change the valuation of lifetime pensions for RBL purposes. On the contrary, they simply shut small funds out of that segment of the market. The RBL valuation of lifetime income streams from large superannuation funds remains the same in spite of the regulations. Furthermore, "RBL compression" can continue to occur under the regulations where a lifetime pension from a small superannuation fund is provided by the purchase of a matching annuity from a life office.

The most effective way to address this matter is not, therefore, to simply ban small superannuation funds from providing such pensions. Rather, the method by which lifetime pensions are valued for RBL purposes should be reviewed. One approach could be to replace the current formula-based RBL valuation with one based on the purchase price of the pension. The formula could remain appropriate for a lifetime pension that does not have a purchase price as may occur in a corporate defined benefit fund or public sector scheme.

The existing provision in Section 140ZO of the Income Tax Assessment Act 1936 requires the formula-based approach to be used for all lifetime pensions. To enhance the integrity of the RBL system this section could be amended as follows:

- Subsection (1) will only apply to lifetime pensions that are not purchased,

- Subsection (2) is amended to allow the Commissioner to issue a determination for calculating the capital value of any pension with a purchase price.

The Commissioner can then issue a Taxation Determination for purchased lifetime pensions on the same basis as Taxation Determination TD 2000/29, which deals with the capital value of other "purchased" pensions (such as allocated pensions).

Taking these actions would align the RBL treatment of lifetime pensions with purchased lifetime annuities, as well as addressing the RBL compression aspects.

An alternative approach could involve a revision of the factors that are required to be used for the valuation of lifetime pensions under the Tax Act and/or a review of the actuarial standards prescribed in the SIS Regulations for the calculation of defined benefit pensions (see also the section following).

Aside from the lifetime pension position, we are at an absolute loss as to why life expectancy or fixed term pensions (also categorised by definition as defined benefit pensions) have also been banned from small superannuation funds on a prospective basis. These types of pensions are essentially account-based, albeit the annual pension amount is fixed at their outset. We fail to see any reason why small superannuation funds cannot continue to pay these pensions.

In any event, it is important to appreciate that the regulations reduce the number of choices of income retirement streams available to all new self managed superannuation funds (and small APRA funds) and many existing ones from five to two – with the other three forms only available from large superannuation providers or life offices. This is clearly anti-competitive and discriminatory.

The regulations also contradict the Government's recently stated policy position on retirement income streams. When the Federal Treasurer released the Government's "A More Flexible and Adaptable Retirement Income System" on 25 February 2004, he said in his press release in relation to the new "market-linked" pensions that "The introduction of these products will give retirees more choice in how they can finance their retirement." They are discussed later in the paper accompanying that press release under the heading "Increased choice and competition in the income streams market". It is impossible to see how the reduction of choices available to small superannuation funds under the amending regulations is consistent with these policy objectives.

Size of Defined Benefit Funds and Funds Paying Defined Benefit Pensions

The Government Actuary appears to be of the view that a small number of members in a fund means that risk cannot be effectively pooled and that income payments cannot be guaranteed over the term of a pension. Accordingly, the new regulations require defined benefit funds and funds paying defined benefit pensions to have at least 50 members. In the case of the former class of funds, the requirement is for there to be at least that number of defined benefit members. However, the latter merely requires 50 members (not necessarily 50 defined benefit pension members).

In either case, we do not consider that the number of members is particularly relevant or helpful to the ability of a fund to satisfactorily manage its financial position or provide benefits to members.

Specifically, the financial stability of a traditional employer-sponsored defined benefit fund is underpinned by the performance of its investments and the financial strength of the employer-sponsor—the number of members has no obvious significance.

For funds paying defined benefit pensions, the regulations do not improve the integrity of the system at all well. We fail to see how, for example, a fund with 49 accumulation benefit members and one defined benefit pension member can be in a better position to manage its risks and financial position than a fund with only a single member in receipt of a defined benefit pension.

We have consulted individual members of the actuarial profession on these matters, whose views are consistent with ours. Consequently, we submit that a preferred approach to improving the integrity of the operation of defined benefit pensions is not to focus on the size of the particular fund, but to enhance and tighten the actuarial standards relating to how such pensions are calculated and certified.

In this regard, the current actuarial requirements under SIS regulation 9.31 arguably permit the commencement of a defined benefit pension at an inappropriately low level relative to the capital supporting it. This has the potential for an "artificially" low RBL value and/or unreasonably high benefit reserve to be achieved. This is as a result of the regulation requiring the actuary to express an opinion that a fund has a "high degree of probability" (i.e. 70% probability) of being able to pay the defined benefit pension. The requirement is a minimum one, meaning that a higher degree of probability could possibly be applied, with a lower level of pension as a consequence.

The potential to manipulate this position could be addressed by amending regulation 9.31 to require defined benefit pensions to be commenced with no greater than a high degree [70%] of probability.

We believe that such an approach would ensure that a reasonable and genuine level of retirement income relative to the amount of underlying capital was required to be paid. Furthermore, this would avoid the potential for excessive benefit reserves to arise.

It should be noted that such a modification of the actuarial requirements may in fact negate the need to change the current RBL valuation method applying to lifetime pensions.

Trust Deeds and Pensions

The industry as a general principle actively encourages trustees to review the governing rules of their superannuation funds on a regular basis. This is done due to the need to ensure that not only are the prudential requirements adequately reflected in the governing rules but also that the superannuation fund can deal with the constant changes that will affect eligibility to membership, acceptance of contributions and benefit payment conditions and forms.

It has been suggested that in some instances the trust deed does not permit or adequately match the pensions that a superannuation fund is paying and the ATO is contemplating an audit of trust deeds.

It would seem that the simpler way of ensuring this matching of pensions paid to the fund's trust deed is through the annual audit and actuarial processes.

Within the auditor's responsibilities the auditor has an obligation to ensure the payment of benefits is in accordance with the terms of the SIS Regulations and specifically regulation 6.17. From this requirement it can be concluded that the auditor needs to ensure that the trust deed and governing rules adequately support any pension that has commenced to be paid in accordance with the SIS Regulations.

From an actuarial viewpoint, before the actuary can conduct an investigation of the ability of the superannuation fund to support a pension the actuary would require the governing rules to be able to determine the characteristics of the pension to be paid.

Thus these two professional bodies have obligations to ensure the governing rules of a fund permit the particular type of pension to be paid. The recently introduced "whistleblower" provisions under the Superannuation Safety Amendment Act 2004 have further strengthened the reporting obligations to the regulator.

Estate Planning Concerns

We submit that our proposed alternative solutions set out above also address any concerns that defined benefit pensions are being used for estate planning rather than retirement income purposes. Of course, it must also be remembered at this point that a degree of estate planning is in fact contemplated by section 62 of the SIS Act (under the “sole purpose test”).

We also believe that there were sufficient and effective safeguards already in place to deal with such concerns. Specifically, the following points are relevant:

- Any residual assets on the death of a pension member (or reversionary beneficiary) are retained in the fund to be applied for the benefit of any remaining members;

- Such amounts may become the superannuation benefits of other members, and are therefore subject to the preservation and payment rules under the SIS Regulations as well as ultimate RBL assessment (i.e. RBLs could potentially apply to the same benefit twice);

- Amounts allocated to remaining members are potentially subject to the superannuation contributions surcharge;

- If there are no remaining members and the remaining capital is paid to the deceased’s estate, ETP tax will apply and a new RBL assessment (with possible excess benefits tax) will arise.

- Any reserve in the fund above the level determined by an actuary for income tax purposes (under section 283 of the Income Tax Assessment Act 1936) would not be eligible for exemption from tax, which would otherwise be the case with an allocated pension.

Capital Gains Tax

Not only do the regulations limit the choices that are available to Australians who choose to use a small superannuation fund, they will also serve to reduce the amount available to fund their retirement income streams.

Where a trustee wishes to provide a lifetime or life expectancy pension to a member and has, as the only choice, a life office policy to invest in, the trustee will have to realise assets of the fund to purchase the policy, and hence will give rise to capital gains tax that would not have otherwise been incurred. The result is that retirement income is lower for that retiree. It should also be noted that these products from life offices typically have much higher fee structures than would be the case in a small superannuation fund, and there is not full disclosure of the full fees and charges applicable.

Actions and Summary

Given the above comments we feel that the necessary actions can be summarised as follows:

1. withdraw the recent regulations as they relate to defined benefit funds and defined benefit pensions;

2. review section 140ZO of the Income Tax Assessment Act 1936 in relation to the RBL valuation of lifetime pensions and consider introducing an alternative for purchased pensions; and/or

3. review and tighten the actuarial standards for the calculation of the level of defined benefit pensions on their commencement.

We believe that these actions will not only remove the uncertainty regarding the changes, but will be a **more effective policy for improving the integrity of the superannuation system and remove any potential abuse of taxation laws** which may exist through small superannuation funds.

Further, all of the above actions can be put in place very quickly – with only minor and non-controversial legislative changes.

Importantly, by continuing to allow retirees who choose to use self managed funds the right to choose the type of retirement income stream which suits personal circumstances, the Government will be **strengthening the policy of choice.** It will also contribute to a **level playing field**. The combination of choice and a level playing field should promote competition and hopefully translate to **lower costs for retirees**.

The suggested action also has the added benefits of **eliminating the need for complicated 'grandfathering' and 'transitional' rules** in this area. The superannuation system certainly does not need another set of 'before and after' rules.

We look forward to participating further in Treasury's review.

Yours sincerely

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