Submission to the Review of the provision of pensions in small superannuation funds

From Barbara Smith, CEO, Online Super Pty Ltd

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Introduction

I am the CEO of Online Super Pty Ltd and am a well respected and credentialed expert in the SMSF field. Prior to my current appointment I was the Technical Director of Taxpayers Australia Inc (the Australian Taxpayers Association) for 10 years and the Executive Director of Superannuation Australia, which runs Taxpayers self managed superannuation services. I have written vast amounts of technical information, books and manuals about superannuation in general and about self managed superannuation funds and before that excluded funds over a 15 year period. This has included the CPA's program Personal Financial Planning and Superannuation, The superannuation module of the FPA Diploma of Financial Planning for Deakin University, Taxpayer Australia's DIY Superannuation Manual and the Superannuation Handbook. Over the years I have been a member of many government and ATO committees including the ATO's Superannuation Industry Liaison Group.
Online Super provides a full suite of SMSF services from set-up to assisting SMSF trustees/members to understand their duties and obligations via our Self Managing your Super trustees duties and obligations training course and retirement and superannuation update seminars and to utilise investments in fully compliant strategies to best utilise their fund for wealth creation by way of our unique regular private client workshops and personalised advice where required, through to SMSF annual compliance services. We also assist our clients to understand the features of various income streams and prepare the necessary statement of advice and paperwork to implement the selected alternative(s). We estimate that our current client base comprises of over 3000 trustees of self managed superannuation funds.
In the past our services have tended to concentrate on advice and strategies using direct investments and risk insurance arrangements for those clients who prefer such to the indirect, managed alternative but we also recognise that SMSFs are not appropriate for every client and so advise on other alternatives where this is more appropriate for a particular client. Basically we give our clients control of and assist them to best manage and maximise what is after all their retirement income dollars.

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Overview of retirement incomes

The Government's policies for retirement incomes should encourage people in the workforce to save and where possible, accumulate sufficient savings to self fund their retirement and to reduce the burden on the public purse. This will become increasingly critical in the future with the aging of the Australian population and the retirement of baby boomers.

The main vehicle for long-term retirement income is superannuation and consequently, it should operate to encourage self sufficiency for as long as possible, be non-discriminatory and not be a detriment to that goal.

Once people retire they should where possible be able to retain sufficient capital in superannuation to be able to fund a pension for the remainder of their lives.

Most people who have taken the step of establishing a self managed superannuation fund have done so because they have accumulated a certain level of superannuation and they wish to take control of their retirement savings, and when the time comes their retirement income. Some people plan to, and do take that step at the point when they actually retire.

It is therefore fundamental that a culture of preserving retirement savings is engendered in self managed superannuation fund trustees/members if the government's goal of encouraging self-funded retirement is to be achieved.

Unfortunately some aspects of retirement income need improvement. The Review document emphasises the government's assertion that superannuation is concessionally taxed, but there are many situations where this is not the case when all of the layers of tax applying to superannuation are examined.

For example two-thirds of capital gains made from assets held over 12 months are included in the assessable income of a superannuation fund. This means that they are effectively taxed in a superannuation fund at 10 per cent. It sounds good, until you look through the smoke and mirrors and recognise that in a superannuation fund is not a final tax. Even where the member does not exceed their RBL, Upon later withdrawal as a pension a further tax of up to 33.5 per cent is payable on the remaining 90 per cent of the capital gain, meaning that the total tax on the capital gain is 40.15 per cent. Should there be an excess RBL the overall tax rate can be up to 53.65 per cent. This is not concessional taxing when compared with the final tax of a maximum of 24.25 per cent in the hands of an individual. There is little wonder that retirees seek to get around the reasonable benefit limit (RBL) rules.

The RBL, entry and exit tax and superannuation surcharge rules can also result in a higher overall tax rate being paid on superannuation savings than the tax rules that apply to the same types of investments outside of superannuation. These issues need to be acknowledged in this Review and actioned accordingly.

Certain rules force people to run down their superannuation savings before they die, and some tax and social security rules relating to superannuation discriminate against women. They need rectification, as you will see in this submission.

Different types of pensions

Online Super's experience since the introduction of market linked pensions in September 2004 is that the allocated pension remains by far the most favoured type of income stream to be paid from an SMSF. The market linked pension is being used by people who want to be eligible for a part or full age pension and are particularly valuable for people who have worked past age pension age to maximise their entitlement to the pension bonus scheme. The other people who consider market linked pensions or complying defined benefit pensions are those who will exceed their lump sum RBL. The problem that we see for people taking an allocated and market linked pension is that they are both market linked and the amount that must be withdrawn each year is based on dividing the account balance by generic payment factors on 1 July each year. This can result in higher or lower amounts being payable if most of the assets are in shares that fluctuate in price, especially where there is some manipulation of the price of certain shares listed on the Australian stock market on 30 June. There is therefore a need for an optional mechanism to allow the smoothing of market linked pension payments if this is desired by the recipient. I would favour smoothing over a period of up to five years in order to achieve a more stable income over time, rather than two years as suggested in 5.3.3.

Market linked pensions

Market linked pensions have been a welcome addition to the retirement income options and offer a viable and straight forward option for SMSFs. However there are still some issues of concern that reduce their appeal and therefore their use in SMSFs to date. My experience so far is that there are two distinct attitudes. The first are the people who want to take them for the minimum term possible in order to access the pension RBL to overcome excess benefits, or to increase age pension entitlements. The second are the people who are worried about the longest term not being long enough; they fear outliving their capital and not having enough to fund the years where they are most likely to need expensive medical and nursing home care. As suggested in 5.2.3 and 5.32, longevity insurance would provide a safety net if this was available at a reasonable cost.

Another problem with market linked pensions in an SMSF in the future is that the fixed term means that in the last few years it will not be financially viable to continue paying them from an SMSF (unless there are other members) because of the compulsory lowering of the account balance each year. Although it is suggested (on page 23 of your review paper) that market linked pensions could be commuted on reaching a given birthday and restarted, in order to increase the effective term of the pension, this is messy and confusing and therefore could be expensive to effect at an age where the aging recipient may not be capable of dealing with it.

A more sensible approach is to change the maximum term that a market linked pension can be paid for. I would suggest that a simple approach would be for the maximum to be the recipient's 95th birthday or the recipient's life expectancy rounded up to the next whole number, whichever is the longer (or applied to the reversionary beneficiary where there is one).

A further problem is the reducing account balance. Consideration should be given to allow the option for the remaining account balance to be commuted either when there are only 2 or 3 years to run, or it is below a certain dollar value in an SMSF (say $40,000) in order to avoid excessive costs of accounting, audit and tax compliance, compared to the remaining balance.

Defined benefit type pensions in SMSFs

Since the introduction of the market linked pension, the main reason that people want to use defined benefit pensions is to compress the RBL. The formula that calculates the amount counted towards the RBL has always been the reason this strategy has been used and this issue can easily be addressed by changing the formula in section 140 OZO of the ITAA to prevent manipulation via the use of large undeducted contributions and the method used to assess the amount counted towards the RBL. We agree in principle with the suggestion in 5.2.1 that two approaches be implemented together, that is, using a purchase price approach where there is a clear purchase price and updating the pension valuation factors for public sector and corporate defined benefit funds where there is no identifiable purchase price. Whilst these changes would reduce the demand for defined benefit pensions in small funds the option should still be available, and new pensions such as those suggested in the report at 5.4 should be considered.

A simple approach to the RBL problem for some people

Currently allocated pensions are assessed against a person's lump sum RBL (currently $619,223). This is not enough capital to provide a fully self funded income for people who live past their statistical life expectancy.

Access to the pension RBL can only occur where a person takes at least 50% of their benefits in the form of a complying pension, so that a person with $700,000 needs to take at least $350,000 as a complying pension such as a market linked pension or a life time pension which pays a very poor return, otherwise they will have excess benefits.

We suggest either simplifying the current overly complex RBL rules (which very few people fully understand) by allowing people to use the full lump sum RBL and then taking a complying pension for the remainder without an excess RBL arising or the introduction of an allocated pension RBL of $928,834 which is 1.5 times the lump sum RBL and 75 per cent of the pension RBL (currently $1,238,440) would encourage more superannuation savings so that retirees have sufficient to fully self fund one allocated pension instead of dealing with the complexities of the pension RBL and two different income streams. In return for the benefit of the higher RBL lump sum withdrawals could be limited to no more than 10 per cent of the account balance on 1 July each year until the account balance is below a specified amount (say $40,000), at which time the balance could be withdrawn if desired to avoid excessive costs of accounting, audit and tax compliance, compared to the remaining balance. This approach would have the effect of preserving capital in superannuation which otherwise might be spent and also reducing the number of people applying for a part age pension as the whole account balance is counted for assets test purposes.

Allocated pensions

Allocated pensions are a great concept for non-government employees who do not have the advantage of an entitlement to a guaranteed life-time pension funded by taxpayers. Allocated pensions have flexibility in the annual drawdown of income so long as it is between the minimum and maximum payment factors. However, there has for many years been an urgent need for these minimum and maximum payment factors to be revised. These factors were devised in 1992 and aimed to provide a reasonable income stream being paid until age 80. They were based on the fact that on average a 65 year old male lived for a further 13.8 years died at 78.8 years old. They are a generic set of factors that apply equally to males and females and did not take the longer life of females into account as back in 1992 females has a further 18 years to live and so on average died at 83 years old.

Where the maximum amount is withdrawn each year, the income runs down rapidly when a person is in their 70’s and runs out at age 80, regardless of gender.

In the scheme of things the payment factors should have been revised each time that life expectancy factors were revised but have not been changed since they were first formulated despite the increase in life expectancy four times since then (see Table 1 below). The life expectancy for a 65 year old male has increased by 3.9 years to 82.7 years and for a female by 3.15 years to 86.15 years.

Therefore, these factors need revising urgently, especially the minimum factor, to reflect the increasing life expectancy and to take the longer life of women in the calculations. We suggest that there is need for more than just a simple revision. A revised generic set of factors should be used to calculate the minimum and maximum withdrawals each year. In addition a generic life expectancy should be developed for calculating the deductible amount and the exempt income amount to remove the current anomaly, which as you will see below discriminates against women.

The inappropriate use of life expectancy tables

The life tables were originally devised by actuaries for life offices, to calculate the risk, including when they undertake to pay an income stream for life. However, in allocated pensions it is the individual who carries the risk, and females already have a greater risk because they are likely to live longer. Yet, as no tax is payable on the annual deductible amount when it returned to the investor as part of a withdrawal, the male with the shorter the life expectancy, gets the higher the tax free amount. Because women have a longer life expectancy, they have been penalised by the actuarially calculated life tables and receive a smaller income stream than their male counterparts for the same investment.

Allocated pensions are just another form of holding investments. As with any investment, before capital is committed a person's unique characteristics, needs and circumstances need to be considered to decide whether an allocated pension is an appropriate investment. An additional factor to be considered in the case of allocated pensions is whether the investor is male or female.

The method of calculation of the annual tax free part of allocated pension income (or in fact any income stream based on life expectancy or life time) results in females paying more tax on their own money than their male counterparts.

In an allocation pension, an individual account is kept for each person, and, in a similar way to a bank account, investment income is added to the balance and payments and investment costs and losses are deducted from the balance of the individual account.

Yet because the life tables being used to calculate a tax deductible amount, where there are undeducted contributions, post June 1994 invalidity component and/or a CGT exempt component females may pay more tax on an allocated pension than a male, even though allocated pensions are funded with the person's own accumulated superannuation savings.

In addition Centrelink disregards a lower amount for females under the income test because this amount is worked out by dividing the account balance by life expectancy.

The use of the life tables are used totally inappropriately for both taxation purposes and Commonwealth Government income support payment purposes to calculate the exempt income amount where the risk is retained by the investor. Women who invest the same amount in superannuation as men during their working life should not be penalised by both the tax and social security system solely on the basis of their gender.

Table 1 shows changes in life expectancy, the deductible amount and social security exempt income for males and females age 65 for an annuity or allocated pension with an account balance of $150,000 and $100,000 undeducted contributions which started.

Table 1 clearly illustrates that:

- as life expectancy factors increase, the deductible amounts decrease and the social security exempt income amounts decrease; and
- as females have a longer life expectation than males, females have a lower deductible amount and lower exempt income than males.
- There has been a revenue win/win for the government and the ATO, while retirees are the losers.

TABLE 1

	1/9/88 to 30/4/93		1/5/93 to 31/12/95		1/1/96 – 31/12/99		1/1/00 – 31/12/04		1/1/05 - present	
	Male	Female	Male	Female	Male	Female	Male	Female	Male	Female
Age 65 life expect-ancy	13.80	18.00	14.60	18.56	15.41	19.26	16.21	19.88	17.70	21.15
Tax deduct-ible amt	$7246	$5556	$6849	$5388	$6489	$5192	$6169	$5030	$5649	$4728
Social security exempt income	$10869	$8334	$10273	$8082	$9733	$7788	$9253	$7545	$8473	$7092

It has been well documented over the years that women have less retirement savings than men. There can be no justifiable reason why the life expectancy factors are used to calculate a lower tax deductible amount for females and a lower amount of exempt income for social security purposes for females. The following example illustrates the point.

Example

The maximum PVF is 8.1 for a 65 year old male or female with an AP account balance on commencement of $150,000 on 1 July and undeducted contributions of $100,000. The maximum payment in that year is calculated:

Account Balance/PVF = $100,000 ÷ 8.1 = $18,520 rounded to nearest $10.

The maximum PVF is 1 for a 80 year old. The whole amount can therefore be withdrawn at that time, ie. with an AP account balance on 1 July, the maximum payment in that year is calculated:

Account Balance/PVF = $ account balance ÷ 1 = $ account balance

ie. if the Account Balance is $15,000, the maximum payment for an 80 year old is $15,000.

The male has an annual deductible amount of $5,649 and has received tax deductions of $84,735 at that time and if the account balance is nil that is the end of the tax deductions.

The female has an annual deductible amount of $4,728 and has only received deductions of $70,920.

When would a male or female get all of their undeducted contributions back?

Using current life expectancy tables the male gets his undeducted contributions back by the time he reaches 82.7 years old provided that he still has money in the allocated pension. If he lives past this he just keeps getting the same deduction.

The female does not get her undeducted contributions back until she reaches age 86.15 years old.

If a male and a female of the same age:

- started an allocated pension at the same date, with the same account balance,
- withdrew the same amounts annually, and
- died at the same date before the account had been exhausted,
- each would have the same account balance during their lifetime, and at the date of death. Yet the deductible amount differs where gender differs.

As I have already pointed out the difference in the deductible amount discriminates against females, as it causes females to pay more tax than males.

Yet the male and female use the same generic tables to work out the minimum and maximum amounts they must adhere to each year.

A comparison of the difference in tax payable for males and females, as a result of life expectation tables prescribing a longer life to females reveals the problem for females.

Allocated pensions and reversionary beneficiaries

Where an allocated pension has a reversionary beneficiary, the life expectancy used to calculate the deductible amount (see above) is the longer life of the primary and reversionary beneficiary. Where a younger woman has an older male partner this exacerbates the reduction of the deductible amount. Because the life expectation of females is approximately 3.5 years more than males. As a result is may not be financially prudent for a male to nominate his spouse as a reversionary beneficiary because of the lower deductible amount he will suffer.

Example

Twins Mary and Edward, both single, and both with other annual income which absorbs the tax free area of the social security income test, purchased an allocated pension for $150,000 on 1 July 2005 when they were aged 65 from an ETP made up of:

$100,000 undeducted contributions and $50,000 post June 1983 component.

The minimum/maximum allocated pension withdrawal factors used to calculate the prescribed lower and upper annual withdrawal limits are 15.7 and 8.1 respectively for both of them, thus they must both withdraw between $9,550 and $18,520 in year 1.

For Social Security income test treatment purposes

Mary's life expectancy from life expectation tables is 21.15 years

Her annual exempt income = $7,092

Edward's life expectancy at age 65 is 17.7 years

For Social Security income test treatment purposes:

His annual exempt income = $8,473

If both withdraw the minimum about of $9,550 from their respective allocated pensions in year 1,

Mary's age pension will reduce by 0.4($9,550 - $7,092) = $983.20 pa

Edward's age pension will reduce by 0.4($9,550 - $8,473) = $430.80 pa.

If both withdraw the maximum amount of $18,520 from their respective allocated pensions in year 1,

Mary's age pension will reduce by 0.4($18,520 - $7,092) = $4,571.20 pa, whilst

Edward's age pension will reduce by 0.4($18,520 - $8,473) = $4,018.80 pa.

The bias: Regardless of whether the minimum or the maximum (or some amount in between) is withdrawn, Edward therefore receives $552.40 more pension than Mary in year 1 and a similar discrepancy in favour of Edward will occur each year.

For tax purposes

Mary's Deductible amount = <u>$4,728</u>

If she withdraws the maximum she can reduce her assessable income from the pension by $4,728, and

Will get a tax rebate of ($18,520 - $4,728) x 15% = $2,068.80

Edward's Deductible amount = $5,649

If he withdraws the maximum he can reduce assessable income from the pension by $5,649, and

Will get a tax rebate of ($18,520 - $5,649) x 15% = $1,930.65

The bias: Edward can reduce his assessable income by $921 more than Mary in Year 1. Because his taxable income is reduced, his rebate will be $138.15 less than Mary's.

Summary on gender bias in retirement

There are just too many areas of retirement income policy that have not considered, do not cater for, and discriminate against females. This area has been the subject of many submissions and articles by myself, and others including ASFA.

To illustrate how long this matter has been ignored, in response to an earlier version of this information that I presented to the (mostly male) delegates at the 1996 Australian Taxpayers' Association National Conference they unanimously passed the following resolutions:

"The current gender bias in allocated pensions is not supported by the Australian Taxpayers' Associations".

"The tax deduction for the capital cost of an allocated pension i.e.; undeducted purchase price be based on the lesser of the life tables and the number of years between the date of first payment and age 80."

The government and ATO have had a silent windfall gain both in increased tax and social security savings each time the life expectancies of Australians have been adjusted upwards. They have been having their cake and eating it too. If they choose to require men and women to withdraw the same minimum amount of allocated pension via generic factors then they should treat both the same when it comes to calculating the tax deductible amount and the exempt income for social security purposes.

An equitable approach must come out of this Review so that the anomalies that currently exist are removed without further delay.