FINANCIAL PLANNING ASSOCIATION
of Australia Limited

FPA SUBMISSION

TO

THE TREASURY

General Manager,
Superannuation, Retirement and Savings Division

THE REVIEW OF THE PROVISION OF PENSIONS IN SMALL SUPERANNUATION FUNDs

1 October 2004

Review of provision of pensions in small Super funds

i. Submission Purpose

After a considerable backlash against its Budget 2004 decision to stop Self Managed Super Funds (SMSFs) from running defined benefit (also called 'lifetime') pensions, on 23rd June the Government announced a review to examine options for small superannuation funds to provide pensions to their members.

The Review's Terms of Reference note that:

1. The Government has been advised of concerns with small superannuation funds providing defined benefit pensions, namely:
   - Access to unintended tax and social security benefits, particularly from the use of Reasonable Benefit Limit (RBL) compression.
   - Their use for estate planning purposes in the superannuation system outside what was intended and not available to other superannuation fund members.
   - Whether a small number of members can effectively pool risk and guarantee income payments over the term of the pension.

2. The Review will examine options for small superannuation funds to provide pensions to their members, including consideration of:
   - Design features of prospective pensions that address the Government's concerns and that could attract complying status for taxation and social security purposes.
   - Management of investment, liquidity and mortality risks.
   - Likely future demand for pensions with defined benefit characteristics.

This Submission is the FPA's response to that *Review of the Provision of Pensions in Small Superannuation Funds*.

ii. Executive Summary

The FPA supports:

- encouraging people to plan for and voluntarily self-fund their retirement
- efforts to limit the use of superannuation arrangements as a vehicle to avoid tax or to abuse asset-test exempt pensions.

We also believe that Choice is rightly the cornerstone of the Government's Superannuation Policy; and that unreasonably 'closing off' the choice to decide **where** to get your retirement income and **what form** the income stream takes does not 'sit' with this position.

SMSFs are an important and popular vehicle for those providing for their retirement. Whilst the evidence shows that only a small proportion of SMSFs run defined benefit pensions, many retirees and advisors questioned why the Government opted to reduce Choice; and why there was such single-mindededness about some unquantified **potential** future revenue leakage.

Also, the FPA was concerned that the Budget decision:

- was evidently formulated without the industry consultation that might have avoided some unintended consequences
- might disadvantage those who had already chosen the SMSF route for legitimate reasons (ie, for more flexibility and control of their retirement funds)
- caused uncertainty and anxiety amongst:
  a. retirees, including many who are clients of FPA members, with long-term plans developed over a number of years
  b. some of our members, particularly the 'small business' financial planners with a significant proportion of clients approaching retirement age.

The FPA also submitted and continues to believe that anti-avoidance and prudential aims can be met by other means, particularly by changing the RBL treatment (see 3.3) and tightening actuarial guidelines (see 3.6.2). This would maintain the integrity of the Choice policy in place.

In this Submission, the FPA:

a. outlines its concern with the way the Budget decision about SMSFs and defined benefit pensions was made and communicated
b. reaffirms the importance of Choice of fund and of income stream
c. reaffirms its commitment to addressing compliance and anti-avoidance aims
d. suggests other ways (than compromising Choice) to address these aims
e. argues that there is exaggerated concern about the tax deferral potential of SMSFs offering defined benefit pensions, and that the estate planning benefits of these pensions can actually reinforce Government strategies to constrain future demand for income support, particularly the age pension
f. comments on:
   - design features of prospective pensions
   - management of investment, liquidity and mortality risks
   - likely demand for pensions with defined benefit characteristics
g. raises other issues to be addressed, particularly about grandfathering and transitional arrangements
h. calls on the Government to act in a way which takes a 'whole of government' approach and a longer-term perspective on this issue (see 4.5)
i. reconfirms its offer to act as a sounding board for policy proposals related to retirement policy and related tax policy, and guarantees to keep these discussions confidential, especially where revenue concerns are involved.

1. Introduction

1A. About the FPA

The Financial Planning Association of Australia Limited (FPA) is the peak professional organisation for the financial planning industry in Australia. With approximately 14,000 members organised through a network of 31 Chapters across Australia and a state office located in each capital city, except Darwin, the FPA represents qualified financial planners who manage the financial affairs of over five million Australians with a collective investment value of more than $560 billion.

1B. Meeting legitimate objectives without eroding Super's acceptability

The FPA understands that the Government:

- has concerns with self-managed superannuation funds
- wants to address arrangements which:
  - exploit superannuation tax concessions
  - circumvent the social security means test.

We support efforts to plug the use of superannuation arrangements as a vehicle to avoid tax or to abuse asset-test exempt pensions.

Whilst we respect the Government's anti-avoidance aims, however, **how** these aims are met and the stability and public acceptability of the superannuation regime are also important (see Part 2).

We acknowledge (as we acknowledged in our June submission) that there has been some such inappropriate use of SMSFs, particularly the use of their reserving strategies to avoid tax and allow wealthier retirees to access age pensions and compress RBL calculations.

However, we suggest that these could be addressed without compromising Choice (of income stream) for a significant portion of the population.

The key point that we want to make here is that the vast majority of existing SMSF members use these funds in 'good faith' for legitimate reasons and follow perfectly reasonable (rather than aggressive avoidance) strategies. In an attempt to 'capture' the small minority who exploit SMSFs to avoid tax and to 'double dip', the majority of 'in good faith' members planning to use SMSFs to run defined benefit pensions will be disadvantaged.

1C. We welcome this Review but emphasise the risks of ad hoc changes ('Don't move the goalposts'!)

The FPA welcomed the Treasurer's February 2004 announcements:

- encouraging people to prepare and plan for their retirement
- outlining various measures to improve the accessibility, flexibility and integrity of the retirement income system and to reduce red tape.

As the FPA has emphasised in previous submissions:

- superannuation is one of the most tax effective savings vehicles
- we strongly support the encouragement of greater voluntary consumer savings for retirement
- superannuation's public image has been tarnished by structural complexity and ad hoc 'tinkering' or redesign.

As you know, we were disappointed with the Government's Budget decision preventing SMSFs from running defined benefit pensions. As we emphasised in our June submission to then Assistant Treasurer and Revenue Minister, Senator Helen Coonan:

A. Announcing sudden 'changes of direction' without consultation and 'working through' the impacts can not only compromise policy making and community goodwill but public confidence in superannuation.

B. The way in which the Budget 2004 decision was announced left those Australians who had been actively planning for their retirement shocked that there was regulatory risk surrounding their plans.

C. The perception that the 'goalposts' might continue to be moved with little or no warning is likely to damage superannuation's public acceptability and use.

Also, our submission to Senator Coonan:

1. Acknowledged that the Government had sought to achieve legitimate compliance and anti-avoidance aims.
2. Suggested that there were alternative ways of achieving these aims.
3. Reiterated that the decision would have unintended negative consequences.
4. Suggested that (and how) these unintended consequences might be minimised.
5. Strongly emphasised that there should be no further fundamental changes to the superannuation regime until proposed changes had been thought through in consultation with stakeholders including the industry associations of practitioners such as financial planners.

We welcomed: the Government's subsequent review of its Budget-announced decision; and the announcement of this Review that you are now conducting. We believe that your Review should fully consider **all** the 'pros & cons' of small funds offering defined benefit pensions.

More broadly, we:

- counsel against further ad hoc changes to the superannuation regime and particularly to the types of pensions which SMSFs can offer
- hope that you 'look beyond' your understandable focus on potential revenue leakage and conduct this Review with 'the bigger picture' in mind. (See our concluding remarks.)

2. Background

2A. The need for a stable Super environment

Superannuation's public acceptability is damaged by ad hoc change to the superannuation regime.

In the wake of the Budget decision to stop SMSFs running defined benefit pensions, we anxiously hinted that the decision might lead to a perception that superannuation funds are subject to political interference and that superannuation might therefore not be a 'safe bet' for those wanting to invest in their post-retirement future.

Our members anecdotally report that many clients (even those who hadn't been planning to have an SMSF run a defined benefit pension) were not only bemused by the Government's decision, but now appear more reluctant to invest in a system that might go through many more changes before they retire.

In order to maintain superannuation's public acceptability, further change should only follow considered review and broad-ranging consultation. This is a contributing reason why we not only welcome this Review, but emphasise that it should also at least 'show willingness' to take a longer-term perspective and to consider the 'bigger picture' (see 4.5).

In this respect we quote SMSF specialist Tony Negline who recently said:

> "If only policymakers would see the benefit of leaving the retirement system alone for at least five years. This is the only way that knowledge of the system would increase. We would also get some breathing space so that we could judge what is good and what is bad about the system." [1]

2B. The importance of income stream Choice

It is important for Australians to be able to choose between a lump sum or income stream and, if the latter, between a variety of income streams.

We believe that:

- Choice encourages people to prepare and plan for their retirement
- Choice is rightly the cornerstone of the Government's Superannuation Policy
- closing off a valid option does not 'sit' with the Government's stated Choice position.

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[1] Tony Negline, *Call time out for planners – investors need to confirm that their strategy will survive legislative and living changes*, <u>The Australian</u>, 1.9.04, p 9.

After the Budget decision about SMSFs was announced, we questioned if it was fair to 'move the goalposts', particularly when those who had already made the decision to set up an SMSF and run a defined benefit pension couldn't simply rethink their strategy (without much extra effort and cost).

In view of the decision, many members and their clients have questioned the commitment to Choice. They cannot understand why retirees using SMSFs should not be able to choose a defined benefit pension.

Although the new market-linked pension has many desirable features in providing flexibility and greater incentive for market performance, it also has some disadvantages vis-à-vis defined benefit pensions, including that market-linked pensions are more likely to 'run out' before the member dies [2] and will provide a variable pension income. In short, and as enlarged upon in 3.2 & 3.4, many retirees are likely to continue to prefer a steady indexed defined benefit pension in retirement.

We therefore repeat a key point of our June submission to Senator Coonan – why limit Choice of income stream when you don't have to for anti-avoidance reasons?

Risks of adopting the SMSF option for the 'wrong reasons'

We acknowledge that Treasury and other departmental advisers have certain reservations about the prospect of Choice prompting a 'mushrooming' of SMSFs and their use by those who might lack the expertise to efficiently and effectively manage their superannuation assets. We note, however, that this can be addressed by better education of current or intending SMSF members about their obligations and responsibilities, more / better actuarial guidance and the tightening of actuarial guidelines (see 3.6.2).

ASIC is also concerned that, in the post-Choice environment, many consumers will not be able to make informed decisions about changing superannuation funds; or that they might be talked into decisions (eg, moving into or out of superannuation funds) that are not necessarily in their best interests.

As outlined in 3.1, the FPA underlines the importance of people obtaining **professional advice** in order to make sound decisions about their retirement needs and how to meet them.

[2] Given increasing life expectancy, more than 50% of people would be expected to outlive their current official 'life expectancy'. Those who do not have other income on which to depend (ie, those who have <65% of their pre-retirement earnings) will inevitably 'fall back onto' the aged pension. Could Treasury explore other means of guaranteeing payment for lifetime (by inclusion of life policies) for years in excess of life expectancy?

2C. Unintended consequences of the Budget decision re SMSFs and defined benefit pensions

The Budget decision confused many Australians about what superannuation options remain available and prompted many Australians to put their retirement decisions 'on hold' until the overall superannuation position is clearer.

The FPA was concerned that the Budget decision:

- was formulated without the industry being consulted
- might disadvantage those who have already chosen the SMSF route for legitimate reasons (ie, for more flexibility & control of their retirement funds)
- caused uncertainty and anxiety amongst:
  a. retirees, including many who are clients of FPA members
  b. some of our members, particularly the 'small business' financial planners with a significant proportion of clients approaching retirement age.

We submitted and still believe that the Budget decision to stop SMSFs from running a defined benefit pension had other unintended negative consequences. Whilst most of these related to superannuation and planning for retirement, inevitably there were some unintended negative consequences for the Government – which faced a political backlash that prompted this Review and extension of the period (to 30 June 2005) in which SMSFs could start to run defined benefit pensions.

Undoubtedly, Australians were left with the impression that the Government did not necessarily 'practice what it preached' in relation to investing in retirement and thinking through the consequences of all relevant options.

It would be difficult to estimate how much damage the Budget decision about SMSFs (and the way it was made and communicated) did to the Government's image and credibility. In the face of the political backlash that eventuated, the Government must have wondered why the advice it had received had:

- been so mono-dimensional – focused as it was on the prospect of some future potential (unquantified) revenue leakage
- been so unequivocal – not even acknowledging that there might be other and better ways of achieving anti-avoidance aims
- not included some warning that the Government might face a political backlash for:
  - making a decision which threw retirees' plans into confusion and which could be seen as attacking Choice
  - the way in which the decision was made – without consulting practitioners who could have suggested other ways of achieving anti-avoidance ends and warned of and helped minimise the decision's unintended negative consequences
  - the way in which the decision was communicated – 'cop this, you tax avoiders!'

- moving the goalposts and undermining superannuation's public acceptability.

It is most undesirable that Australians have been discouraged from investing in their retirement. If they do **not** invest in their own retirement, there will be significant government spending and deficit issues 'further down the track'. As noted in 4.5, these issues cannot be addressed from a single perspective – they innately call for a whole of government position. Such a position was not taken (and does not appear to have been thought of) in the lead-up to the Budget decision about SMSFs.

Examples of disadvantage & / or confusion

After the Government's Budget 2004 decision, our members provided us with case studies of how the decision might disadvantage their clients. The attached ***Case Study Appendix*** includes a range of case studies provided by our members, 'washed' of identifying details and included in our June Submission to Senator Coonan.

One member raised the example of a client (a senior executive of a public company) who had just announced, before 12.5.04, that he plans to retire next year. (He was already irreversibly committed to his retirement.) His whole retirement strategy was based on a defined benefit pension from his SMSF combined with an allocated pension. He wanted **certainty of income**, but, after the Budget decision and before the Government reviewed the decision, had no other choice but to invest his large retirement sum in a lifetime annuity purchased from a life office. He understandably resented that his planning and well-considered strategy might not achieve the desired result – due to what he saw as a retrospective change.

After the decision, many financial planners reported ongoing confusion, amongst their clients, about what options were available in different circumstances. Many of those affected were clients who had been 'caught midstream', ie, they had already 'done the planning' to use an SMSF to run a defined benefit pension. They were subsequently anxious that they might not be able to proceed; and that researching alternative superannuation funds and options would be stressful, time-consuming and costly.

Having to rethink a retirement strategy – because the rules have changed or are unclear – can not only cost you more time, effort, money and stress, but can compromise your commitment to planning for retirement.

2D. Consult with us (and we'll keep it confidential)!

We also emphasised in our June Submission that:

- In many past cases, the Government has consulted with industry specialists and other stakeholders including professional associations – **who have respected the need to maintain the confidentiality of discussions**.
- This consultation led to:
    - better knowledge of the realistic options and of each option's pros & cons
    - better policy formulation and implementation
    - better-drafted and more robust legislation and regulations
    - fewer unintended negative consequences and 'ripe for exploitation loopholes'
    - the maintenance of co-operative relations with the industry.

Certainly, the FPA was not consulted before the Government's Budget decision – despite it undoubtedly being the best placed organisation to assist the Government to understand the decision's likely impact on households [3].

If such consultation had occurred beforehand:

- there could have been better (more constructive and effective) policy-making
- the Government could have avoided the decision's various unintended negative consequences including much of the resultant political backlash.

> The FPA and other industry bodies have access to 'hands on' expertise and regularly offer to make this expertise available to government – in the interests of good policy-making. **We guarantee the confidentiality of discussions when so asked**.

As underlined in 4.6, if such consultation is 'the norm', there are more likely to be positive policy **and** political outcomes.

3. FPA COMMENT

3.1 Retirement Planning – the value of advice

The FPA:

A. Has long emphasised the value of Australians obtaining professional financial planning advice to plan and provide for their future.

B. Has welcomed the fact that the major political parties in this country generally recognise the value of Australians seeking such advice and that obtaining good financial planning advice for retirement will be even more critical in the post-Choice environment.

C. Looks forward to working with future governments in lifting Australians' financial literacy and in examining how to ensure that financial planning services are affordable to all Australians, including those less well-off

[3] There was some speculation within the industry and the media that the accountants' industry body had been privy to the decision-making process, but we see no benefit in speculating whether this was the case and, if so, whether it smacks of political favouritism.

Australians who might be most in need of professional advice to plan their future finances.

As noted in 2B, the FPA understands that the Government and bureaucracy (particularly Treasury, ASIC and the ATO) are concerned that, in a post Choice environment, some people will take the SMSF option for the 'wrong reasons' – without understanding that the term 'self managed' does **not** mean 'requiring no management'. The FPA notes that:

A. Opting for an SMSF does not mean that a consumer can or should establish and manage the fund without advice; and that advice might be even more crucial if the client likes the idea of an SMSF but doesn't really have the knowledge, time and/or the will to set up and run one without any assistance.

B. Financial planners have the knowledge and training to understand all the relevant rules, ensure that all options are considered and to recommend the best strategy for their client.

C. Specialist knowledge of SMSFs could be incorporated into financial planners' educational standards, so that they are fully equipped to advise clients in this area.

Also, with respect to the standard of financial planning advice, we note that the FPA is working to:

- reinforce members' Professional Standards
- foster compliance with the Association's Code of Ethics [4] (which, amongst other things, requires members to observe high standards of honesty and integrity in providing financial planning services)
- reinforce our disciplinary program relating to breaches of FPA Rules of Professional Conduct and Code of Ethics
- rid the industry of 'bad apples' (ie, unscrupulous &/or inept advisers)
- identify and address potential conflicts of interest surrounding adviser remuneration.

[4] These mandatory general standards applying to our members are:
- Integrity
- Objectivity
- Competence
- Fairness
- Diligence
- Professionalism
- Confidentiality
- Compliance (with our Constitution, Regulations and Professional Standards).

3.2. SMSFs and income stream type

SMSFs have become increasingly popular in Australia. [5] They encourage active involvement by their members in providing for their retirement [6], and they offer specific choices in terms of:

- investment opportunity
- eventual structure of withdrawal benefits
- closer alignment of investments with the retiree's overall financial objectives, needs and personal circumstances
- more control of costs
- more transparent fees & charges [7].

This is why more than half a million Australians are SMSF members. Whilst only a small proportion of these members (possibly no more than 1% or 5,000) opt to run a defined benefit pension through their SMSF, this option may benefit/attract particular retirees because:

- Defined benefit pensions provide a steady indexed income stream (certainty of income [8]) and the objective is to provide a pension payment guaranteed for life.
- Of estate planning reasons [9], particularly that SMSFs running defined benefit pensions do not involve a capital loss on the member's death – as can occur when a lifetime pension or annuity is purchased from a life company. (See 3.5.)
- It offers more flexibility to run a defined benefit pension for dependants such as handicapped / disabled children in the family. [10]

[5] There are currently over 300,000 SMSFs in Australia (with about $135 billion – representing about 23% of the total superannuation pool), with more than 2,500 starting each month. (In her 7.6.04 talk to an FPA Sydney Chapter lunch, the ATO's Michelle Crosby noted that about 1,500 SMSFs 'wind up' each year.) In number and asset terms, SMSFs are growing faster than other superannuation vehicles; and their average account size is several times that of a standard superannuation fund account. Some quarters expected that Choice of fund would 'speed up' the shift to SMSFs, but the Australian Tax Office has said that there has been no noticeable upsurge in the number of SMSFs being set up since fund Choice was announced.

[6] They achieve this **even if** the member seeks the advice of a financial planner to help them establish and run their SMSF. Indeed, SMSFs provide a vehicle through which planners and their clients can work together to establish a portfolio of assets that the client controls with the planner's advice and management services. Also, in the structure of the financial planning industry, SMSFs support the existence of non-aligned, fee for service financial planning.

[7] It should be noted that SMSFs are providing competition to the big funds and institutions and are exerting downward pressure on fees & charges. Denying new SMSFs the option of providing complying pensions means that, in this area of retirement planning, the competitive pressure felt by institutions is removed.

[8] With defined benefit pensions, the individual has a very good picture of what they'll receive when they retire; whereas accumulation funds 'leave everything to the market' – which means that the individual doesn't know what they'll receive until the day they retire.

[9] Allowing an SMSF to operate a lifetime pension can provide a degree of certainty with estate planning, often retaining death benefits in a preserved superannuation environment. These benefits can then be used to fund retirement benefits for the spouse or children (including disabled children).

[10] Market-linked pensions don't offer the same level of certainty or longevity of income.

Also, as outlined in 3.4 & 3.5, the defined benefit pension retains **planning benefits** because the death benefits are 'locked' in the superannuation fund and **must** be used by the beneficiaries to fund retirement; whereas the death benefits from market-linked pensions are most often paid out as accessible cash (and, as outlined below, can be spent on holidays and other lifestyle options).

It should also be noted that the Budget decision to stop SMSFs from being able to run defined benefit pensions could be seen as discriminatory (given that institutions can still run them) and as anti-competitive.

Why retirees might <u>not</u> opt to buy a lifetime pension from a life company

After the Budget decision, many SMSF members were angry that, if they wanted a lifetime pension, it would henceforth have to be backed by a life policy or a policy purchased directly from a life insurance company. They explained that they:

- had opted to use SMSFs because they didn't want to buy a life office product which, if they die prematurely, involves a capital loss [11]
- did not choose life companies to be the fund manager of their lifetime savings – particularly as:
  - these annuities 'lock away' retirees' funds at low rates of return [12]
  - the fund member might have reservations about the quality of administration and service and the level and transparency of fees
  - some involve relatively heavy exit costs (where applicable).

A number of FPA members report that some clients simply refuse to use life offices to purchase a lifetime annuity. [13]

This might be a key reason why the Government faced a **political backlash** from its Budget 2004 decision – because many strongly independent retirees want to remain **self-financing** and they also want their retirement funds to go to their dependants in the event of their premature death.

Market-linked pensions <u>not</u> a replacement

Whilst the FPA fully supports the introduction of market-linked ('growth') pensions from 20.9.04, we see them as **complementary to** defined benefit pensions and **not as a replacement**.

As suggested above, complying market-linked pensions will not suit all retirees. In particular, they will not suit those that would prefer:

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[11] Unless the annuity has a fixed term, reversionary annuity or guarantee period, whatever amount remaining in the fund (on the member's death) goes to the insurance company (which bears the 'longevity risk') rather than to the member's beneficiaries.

[12] Lifetime and term annuities bought in the marketplace tend to have relatively low rates of return because they have more conservative investment profiles.

[13] Annuities purchased from life offices are generally backed by fixed interest investments – providing a lower income payment than is possible through a more diversified portfolio in an SMSF. This may cause the retiree to 'draw down' more quickly on other investments. This could increase their potential to rely on Social Security later in life. This would surely be another **unintended consequence** of the Budget decision.

1. The **certainty** of a predetermined income with the ability to nominate a level of indexation to help keep pace with inflation. [14]
2. The **flexibility** to choose between complying and 'non-complying' lifetime or life expectancy (fixed term) pensions. [15]

3.3 Reasonable Benefit Limits (RBLs)

There seems to be a misunderstanding that defined benefit pensions are primarily used only in SMSFs to manipulate Reasonable Benefit Limits (RBLs).

We note that:

- the Budget measures do **not** change how lifetime pensions paid from any fund are valued for RBL purposes [16] - so the compression of RBLs is still available as a strategy
- whilst the problems with RBL compression only apply to lifetime pensions and not term-certain pensions, term certain pensions have been 'caught up' in the legislative changes
- changing the RBL formula could largely 'fix' the tax avoidance and revenue leakage problem.

At the Senate Economics Legislation Committee (SELC) hearings concerning the new Regulations (to implement the Budget decision), Treasury addressed the issue of RBL 'compression' and the ATO presented data showing the increasing popularity of this strategy. Some senators were apparently bemused that, given that this evidence seemed to highlight a problem with the formula for calculating RBL amounts for pensions, nothing had been proposed to address this formula.

Also, if the concern is with 'double-dipping' into the age pension, this is likely to already have been dealt with via the cut in the assets test exemption from 100% to 50%. (From 20.9.04, new complying pensions also attract only a 50% exemption from the assets test; and fund members are **unlikely** to be able to manipulate this 50% exemption for double-dipping purposes.)

The Government has suggested that, in limiting funds that can run defined benefit pensions to those with more than 50 members, it is trying to address prudential concerns about paying a defined benefit pension from an SMSF [17] (see 3.6.2). However, as RBL assessment of these pensions has not been addressed, **there is still**

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[14] Fluctuating income from year to year can make it difficult for retirees to plan for the future and to maintain their standard of living. The income is calculated by the actuary such that there is a high probability of paying the benefit for life or life expectancy. This helps retirees better manage 'longevity risk'.

[15] A complying pension allows retirees to qualify for the pension RBL or an Assets Test Exemption, whilst a 'non-complying' lifetime or life expectancy pension offers retirees who do not want to seek these benefits greater flexibility (eg, the ability to retain access to their capital). 'Non-complying' defined pensions are also more suitable than allocated pensions in many circumstances. For example, the payment of a lifetime or fixed term pension to minor children, on the member's death, helps to ensure a much more managed drawdown of capital.

[16] The RBL valuation of lifetime pensions from large superannuation funds (mainly public sector and corporate funds) has **not** been changed.

[17] Whilst the new rules apply to any fund with <50 members (including small APRA funds and small corporate funds) there is little doubt that they are primarily targeted at SMSFs.

scope for tax avoidance in these funds. For example, someone who buys a defined benefit pension from a life office could access RBL 'compression'. This is an important point, and that is why we repeat it later.

Also, Treasury has been concerned that SMSF-run defined benefit pensions allow members who, on retirement, have large balances in the superannuation fund and cannot bring that full amount under their RBL, to 'forfeit' their 'excess' benefits to another member of the fund – usually a spouse – if certain conditions are met. This can be seen as tax avoidance. However, the Government has already largely addressed this concern with legislative changes to prohibit forfeiture.

3.4 The estate planning uses of defined benefit pensions

A key reason why retirees want the option of defined benefit pensions is for estate planning reasons. They don't want the funds that remain in their account when they die to be 'lost' to their beneficiaries.

This is an understandable preference.

Moreover, the provision of benefits for the deceased member's dependants is a 'sole or primary purpose' for which a superannuation fund is (and **must** be) operated.

Some of the Government's departmental advisers have made it clear, however, that they see this ability of SMSF-run defined benefit pensions to 'revert' to beneficiaries as a tax deferral problem threatening future revenue.

The FPA acknowledges Treasury's point that some advertising literature promotes aggressive tax planning advice about how the current and future tax on their retirement savings can be minimised; and that such services and planning are against the spirit of taxation law. We also note, however, that there are other ways, including by using 'teeth' currently available in tax law [18] and by tightening the RBL rules, to prevent adoption of such aggressive tax planning strategies. Most importantly, we do not believe that these practices are widespread throughout the small funds industry.

This perceived 'revenue leakage', has not been quantified; although, apparently, there is concern that it might escalate in the future.[19] **We regard this concern with tax deferral as exaggerated if not misplaced**; and, in 3.4 & 3.5, we explain why.

Whilst publicity has been given to wealthier retirees in SMSFs running lifetime pensions in order to manipulate 'the system' to receive pensions of $70,000 a year tax

[18] There are tax avoidance rules in the *Income Tax Assessment Act* 1936 (which provides the Commissioner with the 'teeth' to deal with any pension set up for the main purpose of avoiding tax) and these could be reinforced via an ATO Ruling and a tightening of the RBL rules.

[19] The SELC Report quotes the views of Treasury's General Manager of Superannuation, Retirement and Saving Division that the decision was taken to 'nip this problem in the bud' – before the proliferation of arrangements for higher wealth individuals to use SMSF-run defined benefits pensions to avoid tax gives rise to significant revenue costs (SELC Report, p 10). As noted in the Report, there has been no quantification of the current cost to revenue, and no estimation of future 'leakage'. Also, as noted by some SELC members, revamping the RBL formula could overcome much of the perceived problem.

free and also to double dip into the age pension, it should be noted that most SMSFs have <$1M in assets and are therefore not being manipulated to receive pensions of $70,000 a year tax free and to double dip. [20]

Also, as noted above, many of these avoidance concerns:

- were addressed by reducing the Social Security asset test exemption from 100% to 50% for new pensions
- could be further addressed by changing the formula for calculating the RBL.

As argued in 4.5, an over-focus on potential revenue leakage has fostered a failure to take a longer-term and whole of government approach. It is both single-minded and single-faceted policy making.

3.5 The positive implications of Estate Planning purposes

As noted above, it is clear that Treasury has concerns with the use, by small super funds, of defined benefit pensions to facilitate estate planning.

With lifetime guaranteed pensions, the funds used to purchase the income stream are transferred into the superannuation fund reserves. This is then invested to meet the pension obligations. Upon death of the owner and / or the 'reversionary' (ie, the person to whom the pension 'reverts'), pension obligations cease. The remaining balance is passed onto beneficiaries (ie, other super fund members) through the **preserved** superannuation system.

We note that Treasury (and the ATO) view this situation as having negative tax deferral implications.

We emphasise, however, that this transfer process does **not** apply in the same manner with term-certain defined benefit pensions. Upon the death of the recipient/s, term pensions will have an estate value calculated and paid out to the dependants as a death benefit Eligible Termination Payment (ETP). Therefore, any such concerns with lifetime pensions should **not** extend to term certain pensions.

If the RBL valuation of lifetime pensions was adequately addressed so that the full value of assessable money transferred into the fund's reserves was captured and assessed, and the actuarial guidelines were amended to ensure that an adequate income stream was paid (as per the deprivation rules applying under Social Security legislation), **the tax deferral issue is significantly minimised** [21].

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[20] Indeed, it has been estimated that only 2-5% of pensions with a purchase price of more than $1M **might potentially be used** (rather than 'are being used') for estate planning and/or tax avoidance purposes. The Senate Economics Legislation Committee (SELC) was advised that very few people exploit these opportunities for abuse. See SELC Report, pp 8-9.

[21] The concern with the tax deferral and minimisation implications of defined benefit pensions arises because of these pensions':

- perceived effect of transferring wealth to the next generation
- ability, under current rules, to reduce the assessable amount for Reasonable Benefit Limit purposes.

This occurs because the part of the purchase price (for these pensions) not required to fund the expected future pension (as certified by an Actuary) is transferred into the superannuation fund reserves. The part that is required to fund the pension is invested to meet the pension obligations.

Not only can the tax deferral issue be largely addressed, but the estate planning process afforded through SMSFs running defined benefit pensions can in fact **support** government retirement income policy, thus minimising future demands on the Age Pension system. This is because balances passed onto beneficiaries from the reserves of a super fund are **fully preserved**. They are also included in the beneficiaries' RBL assessable amount. There is no scope for the beneficiary to spend these amounts before meeting a condition of release (normally retirement). Another positive factor from a tax perspective is that, when the reserves are allocated to a member who has not met a condition of release, the investment income from this capital (previously tax free reserves) is taxable at 15%. Therefore, death benefits are effectively used to boost retirement funding and reduce the next generation's reliance on government income support, without avoiding the RBL limits that the Government imposes on individuals. Additional income tax should also be collected from the beneficiaries' accounts in SMSFs.

If the tax deferral issues can be addressed in this way, then there appears to be little reason why people can't have defined benefit pensions in their SMSFs.

As outlined in 3.4, there are legitimate reasons why people choose defined benefit pensions. The three key reasons are because they want:

- the certainty of income
- the ability to properly diversify their investments
- retention of the remaining capital for the benefit of their own family etc.

Not all of these important aims can be met if SMSF members are forced to purchase lifetime guaranteed income streams from a life insurance company because:

1. There is no diversification to reduce the risk of life company failure (this is very important considering the large sums involved, the long time frame and the lack of liquidity).
2. All capital is deprived from their families.

This is because it is unattractive to buy a number of pensions from different life companies (due to economies of scale), the life companies back their pensions with a limited range of investments and any remaining balance upon the recipients' death is retained by the insurance company in reserve to support obligations to other clients. This provides the opportunity for the life companies to build up even larger reserves in a tax-free environment - which would seem to defeat the tax-driven purpose of banning defined benefit pensions in SMSFs.

If the only way an SMSF member can have a defined benefit pension is to buy one from a life company, retirees might choose not to use these pensions. All other

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Upon death of the recipient (&/or the 'reversionary' recipient), pension obligations cease. The remaining balance is passed onto beneficiaries (ie, other super fund members) through the preserved superannuation system.

Another way to reduce tax deferral through manipulation of the amounts assessable for RBL purposes, would be to make sure that the full value of assessable money transferred into the fund's reserves was captured and assessed for RBL purposes. That is, the Actuaries could (and should) still set aside prudent reserves but the RBL excess benefits tax would not be deferred or avoided.

income stream options (ie, term certain, market-linked and allocated pensions) will pay a lump sum upon death (where there is no reversionary) to the beneficiary. This is paid as ordinary money and is **fully accessible to spend on current lifestyle needs and expenses**. This could result in increased investment in the beneficiaries' tax-free family homes and increased future reliance on government income support.

It appears that prohibiting defined benefit pensions in an SMSF is an overly aggressive way to solve the problem at hand and can result in some negative policy outcomes.

Our **recommendatio**n is rather to address the Reasonable Benefit Limit (RBL) and actuarial guidelines (see 4.7 below).

This should result in less disruption for retirees, more certainty and confidence in the superannuation system, reduced leakage of current tax and reduced future reliance (than there would otherwise be) on the age pension system.

In conclusion, we suggest that:
- Estate Planning concerns should be minimal.
- there is nothing to prevent this Review from examining how a residue (left in a fund account after the SMSF account owner's death) should be treated.

Summary of FPA Comment – Tax Deferral / Minimisation and taking a longer-term perspective

We understand that Treasury and the ATO have concerns about Tax Deferral / Minimisation and Age Pension access by SMSF members using defined benefit pensions. However, for the following reasons, we believe that these concerns could be adequately addressed by other means (including by fine tuning the Regulations):

1. Term certain pensions do not defer tax to the next generation and do not defeat the RBL.
2. With defined benefit pensions, the RBL issues can be addressed by capturing the reserves in the assessable amounts.
3. Also with these pensions, where capital remains after beneficiaries have died and it is passed on to other members of the fund (instead of to the **tax-free** reserves of a life office), the capital is then taxed at 15% when allocated to the beneficiaries' superannuation accounts, and is included in the beneficiaries' RBL calculations. It is also 'preserved' (ie, cannot be spent on immediate consumption) until retirement, when it boosts the beneficiaries' capital and should have the effect of constraining demand on the age pension. (Many commentators have argued that the Government should support SMSFs running defined benefit pensions – because this pension is most consistent with its policy of encouraging people to be self-sufficient in retirement.)
4. Banning these pensions from SMSFs:
   - reduces Choice
   - reduces competition for the life offices, and can be seen as anti-competitive

- reduces the options to satisfy the legitimate aims of retirees for certainty of income, proper diversification of investment and retention of capital for the benefit of family
- seems an overly aggressive attempt to solve a perceived tax / revenue issue and was, in the wake of the Budget announcement, widely described as ‘using a sledgehammer to crack a nut’.

Furthermore, preventing SMSFs from running defined benefit pensions will merely **transfer** the tax deferral issue elsewhere - in the form of increased **tax-free** life company reserves. Also, and more seriously from the long-term public policy perspective, it is likely to result in fewer people choosing these ‘lifetime’ pensions for their retirement. In turn, this will result in faster depletion of retirement capital and **greater reliance** on Government Income Support in the future – something no government wants!

3.6 Other Options

3.6.1 Other Options – This Review’s focus

As noted in ‘i’ above, this Review’s Terms of Reference ask for comment on:

1. The **design features** of prospective pensions
2. The **management of investment, liquidity and mortality risks**
3. **Likely demand** for pensions with defined benefit characteristics.

(1) Design Features

Throughout this Submission we confirm our belief that SMSFs should be able to offer flexibility, including the option of defined benefit pensions.

(2) Management of investment, liquidity and mortality risks

The FPA:

1. Notes that the Government’s departmental advisors seem ‘coy’ about why they are so concerned that small funds might not be able to meet their pension obligations.
2. Confirms our belief that the onus is on the Government and its advisers to explore other ways to manage the level of reserving in small funds paying defined benefit pensions - rather than banning these pensions altogether.
3. Welcomes that the Government has:
    - strengthened the fund auditor’s role by requiring them to report breaches to the ATO
    - ‘beefed up’ ATO resources to that it can expand its audit coverage of SMSFs.
4. Notes that evidence to the Senate Economics Legislation Committee suggested that very few such funds (about 0.8%) had had to restructure their

pensions because they could not continue to make payments at the existing level and remain solvent. [22]

5. Suggests that the risk of SMSF-run defined benefit pensions running out of money:
   - is a voluntarily assumed one (and that, if fund members are prepared to take the risk, effectively with their own money, they should be permitted to do so)
   - should be minimised by a good actuary and auditor
   - does not appear to be a significant risk.

(3) Likely demand

We emphasise that the likely demand for defined benefit pensions is not the key issue here. The key issue is 'having the options' (ie, Choice) – so long as the options are legitimate ones that are not structured for the purpose of avoiding taxation obligations or of double-dipping.

Also, we believe that the onus is on the Government and its advisers to:

- try to quantify their concerns with tax deferral (due to defined benefit pension's estate planning features) and this and other perceived revenue leakage
- address any such legitimate concerns by means other than compromising Choice.

3.6.2 Other 'prudential concern' options

The Government has suggested that, in limiting funds that can run defined benefit pensions to those with more than 50 members, it is trying to address prudential concerns about paying a defined benefit pension from an SMSF. [23]

Another way of addressing prudential concerns is to tighten actuarial guidelines and offer more actuarial guidance to members and fund trustees.

We note that prudential concerns about SMSFs running defined benefit pensions are, to an extent, addressed by the requirement that SMSF-run defined benefit pensions **must** obtain an actuarial certificate each year to certify that there is a high probability that the fund can continue to meet its pension liability. [24]

In the last few years, much has already been done to clarify and tighten the actuarial guidelines for SMSFs, particularly those offering defined benefit pensions.

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[22] Also, we see inconsistency (or 'a bob each way') in concern about SMSFs becoming insolvent **combined with** concern about them having 'too much' money left over when the fund member dies and the pension 'reverts' to their beneficiaries.

[23] However, because RBL assessment of these pensions has not been addressed, **there is still scope for tax avoidance in these funds**.

[24] This existing certification process (to ensure that underlying funds are at least sufficient to meet the relevant income stream) could be boosted by other safeguards against unwise / unsafe investment practices by trustees of funds paying complying pensions. Also, we note that the prudential issues are not necessarily a major concern to SMSFs due to the nature of the fund structure and relationships.

We recommend further work to:

- tighten the actuarial guidelines
- supplement ATO resources to reinforce its relevant compliance and educational roles.

We accept that the Government may be concerned about the level of reserving in small funds paying defined benefit pensions, and that there may be inadequate provision or over-provision (although, it is interesting that there has been no attempt to quantify this revenue risk); but we call on the Government to explore other ways to manage this - for example, by requiring greater investment diversification or by reviewing the actuarial standards.

Our recommendations

As noted throughout this Submission, the FPA believes strongly that other ways to achieve compliance and anti-avoidance ends and to address prudential concerns should be explored.

To target abuse but promote flexibility, we **recommend**:

A. Address the RBL by amending the formula for calculating the RBL on a purchased lifetime pension to bring it in line with other purchased income streams, thus making it less generous. [25]

B. Tighten actuarial guidelines and provide more / better actuarial guidance. [26]

C. Use currently available tax avoidance legislation and 'teeth'.

D. Better educate SMSF trustees about their obligations [27].

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[25] There seems to be a misunderstanding that defined benefit pensions are primarily used in SMSFs to manipulate Reasonable Benefit Limits (RBLs). Changing the RBL formula could fix the tax avoidance / leakage problem. However, the Budget 2004 measures do **not** change how lifetime pensions paid from any fund are valued for RBL purposes; and the RBL valuation of lifetime pensions from large superannuation funds has not been changed. If the concern is with 'double-dipping' into the age pension, this is likely to already have been dealt with via the cut in the assets test exemption from 100% to 50%. (From 20.9.04, new complying pensions also attract only a 50% exemption from the assets test; and fund members are unlikely to be able to manipulate this 50% exemption for double-dipping purposes.)

[26] Higher actuarial standards were introduced for SMSFs in 1999, thereby reducing the risk of insolvency. This could be strengthened with further guidance to trustees and to actuaries re appropriate valuations. Also, the Government could look at the relevant rules & regulations to ensure better protection of reserves and reasonable valuations – so pensions are more secure. Given that the Australian Prudential Regulatory Authority (APRA) may have more experience in the regulation of fund reserves, the Government might consider how to utilise APRA's relevant experience in understanding fund security and reserving issues.

[27] The FPA notes and welcomes the recent announcement that the Government will provide an extra $216.4M over 4 years to the ATO to address a number of identified compliance risks, allowing it to expand its audit coverage of SMSFs and its relevant educational role. We also welcomed and commented on the ATO's revised *Guide for SMSF Trustees*.

3.7 Other issues to be addressed

As noted above, there are some transitional and related issues which need to be addressed. The FPA understands that these issues cannot be resolved unilaterally by Treasury, but raises them here as issues which should be addressed at some stage and about which our members, particularly our Superannuation Committee, would be pleased to offer comment and / or advice.

3.7.1 Transitional arrangements and the effectiveness of grandfathering

Because of the way the Budget decision was made, it seems that insufficient thought was initially given to the transitional arrangements.

In particular, no grandfathering arrangements were initially announced for Choice for SMSF members intending to retire between the 12.5.04 start of the new regime and the 20.9.04 availability of market-linked pensions.[28] The Government later addressed this 'date mismatch', but not before superannuation's public credibility was damaged.

There has otherwise been much confusion about the proposed grandfathering provisions, and, as noted earlier, some confusion remains, damaging the propensity of Australians to invest in their retirement.

Whilst the FPA welcomes the attempt that this Review represents to clarify the position of SMSFs and the relevant transitional arrangements, this confusion could have been avoided if practitioners such as our members had been consulted in the first place – before the Budget decision was 'set in concrete'.

The grandfathering applies to pre-12.5.04 SMSFs whose governing rules specifically allow for defined benefit pensions in their 'terms & conditions' [29]. There has been much confusion and conflicting legal opinion on exactly how this applies.

In our June submission to Senator Coonan, we submitted that, where the SMSF member's entitlements have been calculated and finalised but the defined benefit pension had not commenced by midnight 11.5.04, the member should be able to proceed with the defined benefit pension – **regardless** of whether the trust deed includes relevant 'terms & conditions' about the retirement income stream.

We welcomed the understanding of the then Assistant Treasurer, Senator Coonan, that the decision generated much confusion and that clarifying the transitional

[28] In our June 2004 submission to Senator Coonan, we suggested that existing rules governing defined benefit pensions should at least remain in place until 20.9.04, if not to 31.12.04 – so that those members who were in imminent retirement mode **and** had met the compulsory cashing condition had time to review the introduction of market-linked pensions and to compare the options before starting income streams. The Government subsequently extended the period in which SMSFs could start to run a defined benefit pension.

[29] Which would include:

- Who will receive the pension?
- What type of pension is involved?
- How is the pension calculated?
- Is the pension indexed (if so, how?)
- Is the pension 'reversionary'?

arrangements should be a priority. (We also welcomed Senator Coonan's 1.6.04 statement that: "While it's important that the integrity of the super system is enhanced, it must not unfairly impinge on people who are genuinely trying to do the right thing and effectively plan for their retirement within the rules.")

In our June submission, we noted the importance of the further guidance being well-informed and well-considered, so that it didn't simply raise more questions than it answered and so that it addressed key concerns. We also noted the importance of **equitable** 'grandfathering' outcomes – that do not advantage one group over another.

It seems likely, from the majority report of the Senate Economics Legislation Committee (SELC) that examined the Superannuation Industry (Supervision) Amendment Regulations 2004 (no. 2), that these Regulations preventing SMSFs from providing defined benefit pensions will 'stand' without change, despite some less than supportive comments from SELC members. [30]

Governing rules and Terms & Conditions

Each SMSF is established via a trust deed. Historically, some of the relevant documentation has been of a poor standard (ie, incomplete, incorrect and vague, particularly in those sections about the payment of retirement income streams) – although this is now changing.

The Explanatory Statement to the new Regulations [31] stated that:

> "The new division will not prevent a defined benefit pension from being paid by an existing superannuation fund where the governing rules of that fund set out the <u>terms and conditions of the pension</u> prior to the commencement of these Regulations".

The inclusion of the underlined words (our emphasis), which were not in the Regulations, sparked speculation as to the type of trust deeds that could be grandfathered.

Given that many existing trust deeds are not explicit with respect to terms & conditions (not even about who will receive a defined benefit pension), it appeared that few existing funds would meet the proposed grandfathering provisions – because few trust deeds meet the eligibility requirements for an exemption (ie, they do not sufficiently specify the pension's terms & conditions).

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[30] The Committee, which examined the Regulations to implement the Government's Budget decision about SMSFs, reported in August that, in the post-Review environment, there should be consideration of new regulations:

- allowing SMSFs adequate flexibility to provide a range of pensions
- but better targeting potential tax avoidance and double-dipping loopholes.

We hope that the range of issues SELC considered will not now be overlooked just because:

- the majority Report recommended that the Regulations currently stand 'as is'
- the calling of the Federal election has overtaken the outcome of SELC's deliberations and, combined with the ALP's challenge to the Regs, thrown the Regulations implementing the Budget changes into limbo.

[31] The *Superannuation Industry (Supervision) Amendment Regulations* 2004 (No. 2) (Cth) – also known as Statutory Rules No. 84 of 2004.

It was later made clear that exemptions would only be granted in "extremely limited circumstances". [32]

This has resulted in legal compliance issues – as there are terms that may be **implied**. Many superannuation trust deeds allow benefits to be paid in the manner allowed by the relevant laws. As noted in our June submission to Senator Coonan, we submit that these should not be precluded from paying complying lifetime and life-expectancy pensions under the grandfathering arrangements.

Many clients have entered into SMSF structures **in good faith** and on the understanding that their trust deed will allow them access to the pension RBL via one of the pension options when they reach retirement age.

They may have relied on professional advice to that effect, which would also have been based on prior law and would also have been offered **in good faith**.

Is it fair to prevent existing funds from continuing to run defined benefit pensions just because the 'terms & conditions' are not clearly specified in the existing trust deed?

Potential implications if a grandfathering-related issue 'goes to court'

An issue of concern to FPA members is the situation which could arise from a lack of clear direction about what will or won't be allowable under the grandfathering provisions post-30.6.05. If these aren't perfectly clear:

- Some advisers (eg, legal or superannuation advisers) might try to 'work around' the new arrangements and advise their client that they can set up an SMSF to run a defined benefit pension if they do X.
- Others, such as financial planners, might advise their clients **not** to try to 'work around' **the spirit of the changes**.
- If a case went to court and the court ruled in favour of those who recommended 'working around' the new rules, what would be the legal position of the financial planner who had advised his/her client, in good faith, not to try to 'work around' the new rules? Would he/she be liable to be sued for any deemed 'loss' from not adopting the more aggressive strategy that exploited any lack of clarity in the original direction?

Such a lack of clarity would hardly promote a 'level playing field'. It could also leave our members, and others who 'do the right thing' as professional advisers, in an invidious position.

Our members' relevant concerns

The Budget 2004 decision prompted strong reaction from many FPA members. Whilst their main concerns related to the decision's impact on their clients, there were and still are direct impacts on financial planners.

[32] In her 7.6.04 talk to an FPA Sydney Chapter lunch, the ATO's Michelle Crosby (Assistant Commissioner, Superannuation) acknowledged that there would be "extremely limited circumstances" in which an exemption would be available.

Because the Budget 2004 decision was made without industry consultation, little thought appeared to have initially been given to the transitional arrangements.

In the 'interregnum' while transitional arrangements were being clarified, many financial planners were at a loss to know how to advise their clients about their retirement plans. (Nor could the FPA assist its members as much as we would have liked. We had not been privy to the decision-making.) Some opted to pay large sums for legal advice – which may or may not have answered their specific questions. Others 'wore the risk' in terms of 'this is what we think the transitional arrangements will be' – thus exposing them to an unacceptable risk in terms of their business and Professional Indemnity insurance if their predictions about the transitional arrangements proved wrong. This was an unacceptable position in which to place financial planners – who are merely trying to best advise their clients.

The SELC recommended to the Government that the Regulations not be disallowed but apply only temporarily until this Review is finalised. Now that a Federal election has been called and the ALP has challenged aspects of the Regulations, these Regs remain 'in limbo'. This effectively means another 'interregnum' in which financial planners remain in the invidious position of not being sure 'where the goalposts are' for those clients for whom an SMSF-run defined benefit pension might normally be a realistic option.

Until the Government responds to this Review and clarifies **all** transitional issues, financial planners remain in the invidious position of not being able to advise their clients of the **exact** future position with respect to SMSFs and the income streams they can offer.

Also, a number of our members have noted that, in the twelve months to May 2004, they had undertaken specialist studies in how to manage SMSFs (largely driven by a need to comply with the FSR requirements), and that the Budget decision had largely nullified this considerable investment of time and money.

Our 'small business' members have been particularly disadvantaged by having to devote an undue amount of their limited resources to familiarising themselves and their staff about the reforms and their impact and the emergent 'transitional arrangements'. [33]

3.7.2 Mobility between funds

There is the question of whether the grandfathering provisions will curtail mobility between funds.

[33] This imposes a particular burden on those financial planners who:

- have a higher-than-average proportion of retiree clients
- have structured their financial planning practices around advising on how to run a defined benefit pension from an SMSF
- had to outlay considerable resources on reviewing existing (but yet-to-be-implemented) financial plans and considering alternative ways to invest for retirement.

There may be legitimate reasons why someone wants to move from a small APRA-regulated fund to an SMSF or vice versa. For example, SMSF members may become non-resident and have to appoint an approved trustee.

The trust deed change required to effect such transfer may result in the fund loosing its grandfathered status – preventing it from commencing a defined benefit pension.

We believe that these members should not be penalised by the loss of the grandfathered status.

3.7.3 Potential implications of unwinding an SMSF

The Budget decision re SMSFs could also impact on the quantum of retirement benefits if there is a shift from SMSFs to other superannuation funds.

Moving funds might involve exit fees, entry fees and the costs of professional advice and could trigger a Capital Gains Tax (CGT) liability. (Such unforeseen costs could also damage superannuation's acceptability as a preferred savings vehicle.)

For example, if an SMSF trustee opts to provide a member with a defined benefit pension, by purchasing an annuity from a life office, the trustee will have to realise the fund's assets to purchase the policy. This would incur a CGT liability that would otherwise not have been incurred, and would reduce the income available to the retiree.

For existing SMSF members in a business and investing up to 100% of the fund's assets in business real property, unwinding their SMSF will have CGT implications. [34]

It is perhaps not surprising that many of the most vociferous opponents of the Budget's SMSF decision were small business owners who had opted for an SMSF running a defined benefit pension - because this option offered more **flexibility and control** of their retirement funds.

3.7.4 Potential manipulation of RBL when buying a pension externally

An issue raised at the 31.5.04 meeting between consumer and industry groups and Treasury / ATO officers was whether there could be legal complications if the fund trustee was forced to buy a lifetime pension externally. Wouldn't there still be a potential for the RBL to be manipulated to reduce tax – given that the fund doesn't have to pass on the whole amount, but could place some of this into reserves? Could this allow a loophole to manipulate RBL?

3.7.5 Workplace agreements and securing existing vesting arrangements

One of the items Treasury has focused on is progressive vesting to reward loyal employees.

[34] Many SMSFs own the business premises from which their small business is run. (This can be a risk management tool for protecting the business's real assets.) If these clients have to move to another superannuation fund in order to access defined benefit pensions, they would have to sell their business premises, thereby triggering CGT within the SMSF.

Superannuation is said to 'vest' when the member becomes legally entitled to it; and employers use vesting as a 'loyalty incentive' to retain valued staff. [35]

For example, the employer might agree to 'match' the employee's contributions, ie, for each dollar the employee contributes, the employer puts in a dollar. The longer the employee stays, he/she gets to keep more of the employer's 'extra' contributions.

There are occasions where employers pay contributions in advance and these are held in a reserve account until allocated. [36] The contributions are then deducted from the reserve and allocated to members usually monthly, as they fall due, until the amount is exhausted. The FPA was concerned that the Budget decision would encourage employers to seek a refund on these contributions, rather than having them allocated to members. [37]

Many corporate superannuation schemes allow an employer to set up vesting of superannuation benefits. Also, some workplace agreements between the employer and the employee/s specifically provide for vesting.

The new superannuation Regulations state that the vesting of benefits financed by voluntary employer contributions may continue on their pre-12.5.04 vesting arrangement, so long as the arrangement is, amongst other things, sufficiently evidenced in writing. [38] However, this only covers existing employees. This can create issues and remuneration discrimination in the workplace unless the employer seeks and is granted an exemption so that they can offer the vesting scales to all new employees.

We would welcome further grandfathering to allow automatic approval of vesting for new employees where an existing corporate fund or workplace agreement provides vesting scales. Without these measures, many employers may cease to make voluntary contributions in the future; and this would obviously be regrettable.

In short, the FPA:

A. Notes that vesting is a useful 'loyalty' tool and that most defined benefit funds award higher benefits to those with longer service.
B. Would welcome further grandfathering to allow vesting for new employees where an existing corporate fund or workplace agreement provides vesting scales
C. **Recommends** that the Government examine the position with respect to existing workplace arrangements providing for vesting of benefits financed by voluntary employer contributions.

[35] The employer can set up a sliding scale so the employer's extra contributions (over and above the Super Guarantee ones) can be fully vested in terms of years of service, ie, the longer an employee stays, the more of the employer's extra (or non-mandatory) contributions the employee can retain.
[36] This could include employer contributions which missed a Superannuation Guarantee deadline – in which case the employer authorises the payment to be allocated to the next period.
[37] Refunds to employers from superannuation funds create other flow effects involving SIS restrictions.
[38] An issue here is whether the arrangement can be evidenced in the trust deed rather than in an employer/employee agreement.

4. CONCLUDING COMMENT

4.1 The value of good advice

The FPA:

1) Supports encouraging people to plan for and voluntarily self-fund their retirement.
2) Emphasises the value of Australians obtaining professional financial planning advice to plan and provide for their financial future, and to use their adviser's expertise to make their clients' money 'last'.
3) Welcomes that the major political parties in this country generally recognise the value of Australians seeking such advice and that obtaining good advice will be even more critical in the post-Choice environment.
4) Is working to reinforce members' professional and ethical standards.
5) Is looking at how to ensure that financial planning services are affordable to all Australians.

4.2 The risks of Super uncertainty

As outlined in Part 2, superannuation's public acceptability is eroded by ad hoc change to the regime.

A perception that superannuation funds are subject to political interference, and that, therefore, superannuation might not be a 'safe bet', will inevitably erode people's willingness to invest in their post-retirement future.

In order to maintain superannuation's public acceptability, further change should **only** follow considered review and broad-ranging consultation about how best to achieve legitimate anti-avoidance aims **without** limiting Choice and forcing those planning for retirement to rethink their options and strategy.

Also, as hinted in Part 2, 'fiddling with the system' creates resentment and can generate a political backlash.

Whilst we are not saying that no government should ever press for superannuation reform, we are suggesting that related reform should be:

A. Well-considered and emerge from comprehensive consultation with stakeholders including industry associations.
B. Comprehensive and delivered 'in one consistent package' or in discernible and logical stages ('tranches', in the jargon), after considered review.
C. Clear in its purpose and delivery, including in transitional arrangements.
D. Well-communicated to those on whom it impacts.

4.3 Why target Choice when you don't have to for anti-avoidance?

The Budget decision stopping SMSFs from running defined benefit pensions caused many of our members and their clients to question the Government's commitment to Choice.

The question encapsulated in this heading was a major theme of our June submission to the then Assistant Treasurer. It remains a key theme of this Submission, in which we confirm and build upon many of our earlier points.

4.4 Target abuse but promote flexibility – other solutions to stop perceived abuse

The Senate Economics Legislation Committee (SELC), which examined the Regulations to implement the Government's Budget decision about SMSFs, reported in August that, in the post-Review environment, there should be consideration of new regulations:

- allowing SMSFs adequate flexibility to provide a range of pensions
- but better targeting potential tax avoidance and double-dipping loopholes.

The FPA believes strongly that the onus is on the Government and its advisers to explore ways to achieve compliance and anti-avoidance ends without limiting Choice of income stream.

If the Government's concern is with regulatory compliance and plugging avoidance, there are other ways to achieve these ends (without preventing SMSFs from offering defined benefit pensions):

A. Address the RBL by amending the formula for calculating the RBL on a purchased lifetime pension to bring it in line with other purchased income streams, thus making it less generous.

B. Tighten actuarial guidelines and provide more / better actuarial guidance.

C. Use currently available tax avoidance legislation and 'teeth'.

D. Better educate SMSF trustees in their obligations.

4.5 Need to look at the 'bigger picture'

We also emphasise the importance of superannuation reform **not** being motivated solely by short-to-medium concerns with potential revenue leakage – as, it appears, was the Budget decision to stop SMSFs from running defined benefit pensions.

Governments and their advisers should be able to take the broader and longer-term perspective.

Superannuation policy (itself complex) does not stand in isolation from other types of policy, such as Tax Policy and Social Security Policy. These inter-relate with other policy categories. Policy for one category cannot be 'quarantined' from policy for related areas. Or, more accurately, it **should not** be quarantined from related policy.

The 'bigger picture'

We hear much these days about seamless government; and this might be an unattainable aim. But it is certainly less than desirable if governments and bureaucracies do not at least **aim** for an across-government approach - so that policy is developed and implemented in a way that maximises the prospects of meeting agreed ends for **each** of the related areas and objectives.

With respect to the intersection between retirement incomes policy, taxation policy and income support policy, considerations such as the following should feed into the relevant decision-making:

A. The willingness of Australians to invest in their post-retirement future.

B. Public perception of the superannuation system and its stability (ie, that the goalposts won't be changed 'at whim' – without adequate warning and without some reassurance that the overall benefits will outweigh the potential unintended negative consequences).

C. The maintenance of genuine Choice – not only with respect to fund, but, equally importantly, with respect to type of income stream.

D. The maintenance of Choice so that those in SMSFs can have any funds remaining in their account after their death 'revert' to their beneficiaries – so that it is 'preserved' in the superannuation system.

E. The long-term ability of the retirement savings system to constrain future reliance on the government income support system, particularly age pensions.

F. The public perception that, in framing relevant policy, the Australian polity has the interests of all Australians, including retirees, at heart and is not driven solely by medium-term concerns about **potential** revenue leakage.

We note that this Review is being conducted by two bodies well-known for their steadfast objections to SMSFs running defined benefit pensions: the Dept of Treasury and the Government Actuary. We hope that, in your report to the Government, you will be willing and able to 'take the bigger picture'.

4.6 Industry consultation should be 'the norm'

Obviously, the Government is entitled to reform the superannuation system to meet a range of legitimate objectives, including to 'plug' opportunities for tax avoidance and double dipping.

However, if decisions are made without an opportunity to consult with practitioners about how the system works and to foreshadow potential outcomes of particular approaches, ad hoc tinkering could result in a range of unintended negative consequences - whose effect might be to compromise superannuation's public credibility.

Whilst we do not expect government and bureaucrats to be financial planning experts, there is an onus on them to **ask questions** and to consult industry specialists and practitioners to better understand how things do or will work 'in practice'.

As noted in 2.D above:

- In many past cases, the Government consulted with industry specialists - **who respected the need to maintain the confidentiality of discussions**.
- This consultation led to better policy and other outcomes, including better:
  - knowledge of the realistic options
  - policy formulation and implementation
  - legislation and regulations
  - industry / government relations
- The public recognises when change is revenue-driven and 'ill-thought-through'; and might react politically – including 'at the ballot box'.

The FPA and other industry bodies have access to 'hands on' expertise and regularly offer to make this expertise available to government – in the interests of good policy-making. **We guarantee the confidentiality of discussions when so asked**.

If such consultation is 'the norm', there are more likely to be positive policy and political outcomes.

We recognise that such consultation might be less likely where revenue initiatives are involved. However, as noted above, retirement policy, Social Security policy and tax policy are closely linked. A strategy that is solely tax / revenue-driven, to the exclusion or downplaying of other important considerations, is not a 'whole of government' strategy. We believe that a 'whole of government approach' is required here, and that both the Government and its bureaucratic advisers should avoid a myopic 'revenue only' approach to such an issue which, 'further down the line' affects:

- the future financial stability of Australians
- their ability to choose a superannuation option that suits their circumstances
- demand on government income support and the government's capacity to offer income support to those who most need it.

We note that the Senate Economics Legislation Committee (SELC) Report covered this issue of consultation with Industry and that SISFA's CEO, Mr McDougall, stated that industry consultation had generally been very good. However, a senior Treasury official noted that:

> "It has long been government practice that you do not consult on integrity measures. There is a perceived integrity concern in relation to these arrangements, and so you address the law clearly and decisively." [39]

A **non-consultation stance** only suits particular circumstances, eg, where:

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[39] Mr Tony Coles, Manager, Superannuation, Retirement and Savings Division, Dept of Treasury. Transcript of Evidence (proof copy) 9.8.04, p 12. Quoted in SELC Report, p 11. We note that:

- the FPA has a high regard for Mr Coles and for his commitment to the integrity measures
- we also appreciated his invitation, on Treasury's behalf, for us to attend the 31.3.04 industry consultation meeting which discussed the Budget decision regarding SMSFs.

- the perceived integrity risk is clear, definable and quantifiable as ‘considerable’ and can readily be addressed without risking other desirable features such as Choice
- the policy makers are so well-informed of the gamut of policy and practical implications – including financial planning ones – that they can ‘make policy’ and be assured that they have ‘covered all angles’ and can not only predict **all** likely consequences, but can predict them accurately
- the preferred and / or adopted response:
  - does not impinge upon other areas of government policy such as encouraging Australians to plan for and self-fund their retirement
  - will not cause a range of unintended negative consequences
- ‘the law’ can be addressed clearly and decisively (including through clear and decisive grandfathering arrangements where appropriate).

Without wanting to offend any policy makers or advisers, there is reason to believe that this was **not** the case regarding the SMSF decision.

We respectfully submit that ‘in confidence’ consultation would have placed the Government and the bureaucracy in a better position to understand:

- the likely consequences of the decision, including unintended ones
- that there were other ways of achieving legitimate anti-avoidance aims.

The FPA confirms that it is willing and able to:

- assist the Government to explore alternative solutions to plug tax avoidance and social security ‘double-dipping’
- act as a ‘sounding board’ for a range of potential options relating to retirement and superannuation (and also to financial literacy)
- maintain the confidentiality of relevant discussion to develop the ‘right’ solutions – in this instance and others.

4.7 The FPA would be pleased to assist

The FPA would be pleased to assist the Government and its advisers to explore how best to meet compliance and anti-avoidance aims and to address prudential concerns.

Please do not hesitate to contact us if we can assist you in understanding the pros & cons and likely consequences of various reform options. We guarantee to ‘**keep it confidential**’.

SMSF CASE STUDY APPENDIX

Please note: These case studies were gathered by the FPA in May-June 2004 for use in our Submission to Senator Coonan and particularly to highlight grandfathering-related issues for clarification.

Case study 1

Facts:

The client is of age pension age and currently has a complying pension paid from their SMSF.

The client and spouse have a daughter with a mental disability. The daughter has a child. The client and spouse are responsible for both the daughter and grandchild.

A significant factor in the client choosing a complying pension was estate planning – to ensure the continued well-being of his family.

The investment strategy is conservative and diversified across a number of investments. However, if one or more of the investments fail and/or market conditions are unusually negative, there may come a time when the actuary is unable to certify the assets of the fund as meeting the 'high probability test'.

Options available to client, following SMSF reforms:

In this instance, the client will be required to commute the current complying pension and re-start a new pension with different income levels so as to ensure that the fund (and the pension) continue to comply.

Given the 12.5.04 changes, it is unclear whether a new pension that is commenced from a commuted pre-12.5.04 pension is still permissible.

If the client is unable to recommence a new complying pension from their SMSF, the client will need to wind up the current fund or realise assets to be able to transfer the proceeds to a life office annuity product. The disadvantages to the client would include:

- loss of control of investments
- the financial well-being of their extended family being compromised through the loss of capital on the member's death.

Case study 2

Facts:

A 65-year old client is gainfully employed. When his business is sold, he would like clarification that he can rely on his SMSF trust deed for him to be provided with a lifetime (or fixed term non-complying) pension. This sale may occur before 20.9.04 when the new market-linked growth pensions are available.

Options available to client, following SMSF reforms:

The client may have to make a decision in the absence of any detail on how the growth pensions will work.

Case study 3

Facts:

A client is currently in the APRA regime (the client commenced an SMSF before June 1986 and has 3 children, and so didn't qualify to be ATO-regulated under the relevant changes). APRA has asked the client to return to the ATO-regime by removing one member. [40]

Options available to client, following SMSF reforms:

If the client moves to the ATO-regime (and necessarily executes a new trust deed), will the client's situation be grandfathered so that the new deed can pay the same pensions as the existing deed?

Case study 4

Facts:

Mr A is a 72-year old retiree and his wife is 70. In 2003, he owned a number of storage sheds which he operated himself. He had built up assets over many years, having previously been a poultry farmer. The couple have 4 adult children, 8 grandchildren and 3 great grandchildren.

Mr A would define himself as a conservative investor who has largely only ever invested in direct property and term deposits. He has never believed in superannuation, having been unwilling to give control of his assets to anyone else.

However, he had built up an SMSF of $1.2M comprised of direct property, cash and term deposits. Also, the couple had approximately $1.8M in other assets (excluding the family home and vehicles).

Prior to retirement, Mr A built up $1M in undeducted contributions to superannuation, giving him a member balance of $1.5M. On retirement, he wanted to retain access to most of his capital, produce a regular reliable income stream of $80,000 per annum, and ensure that his wife and children were 'looked after' financially.

Mr A was concerned that neither he nor his wife outlive their capital. Longevity is in both sides of their family, and neither wants to end up reliant on the age pension.

He commenced an allocated pension with approximately $385,000 - which produces a minimum income of approximately $31,000 per annum.

He also commenced a fixed term pension with a purchase price of $1.2M, paying a pension of $32,000 per annum indexed with CPI for a term of 30 years and with a residual capital value of $1.2M. Mrs A commenced an allocated pension of $600,000

[40] Note: Funds that did not meet the definition of a SMSF after 31.3.00 remained subject to APRA regulation (c/f ATO regulation) and were required to appoint an approved trustee under Part 2 of the SIS Act 1993 (Cth).

paying a minimum income of $44,000 per annum. Therefore their total income will be approximately $107,000 per annum gross.

Options available to client, following SMSF reforms:

Should Mr & Mrs A live longer then their life expectancies of 83.5 and 85.90 respectively, it is likely that the assets in their allocated pensions will have run out.

However, they should be able to rely on their fixed term pension continuing to pay an indexed income of $32,000 per annum until the end of the 30-year term when they will be aged 102 and 100 respectively.

Had Mr & Mrs A retired after the 2004 Budget, they would have been forced into either of the following options:

- retain their SMSF where they would have been forced to take minimum incomes of $47,620 and $44,450 each off their original member balances of $600,000 each. They would have been in excess of the lump sum RBL reducing the normal 15% rebate to approximately 14.7% each;
- in order to undertake the actual strategy, Mr A would have had to purchase his $1.2M fixed term pension from a life company. The longest term they would offer him is one equal to his life expectancy of 12 years. This would have also meant that he would have to sell the property within his SMSF, triggering CGT implications.

Case study 5

Facts:

Mr & Mrs L are aged 68 and 63 respectively. Mr L had been employed at a local sugar mill for 25 years prior to retirement (at age 65) and in other mills before that. Mrs L had been a homemaker and raised their children. At retirement, they sold their property in a small rural town and purchased a home in a retirement village on the coast.

Mr L commenced an asset test exempt pension for Centrelink purposes, with a purchase price of $133,000 paying an income of $11,500 per annum for a fixed term of 15 years. Mrs L commenced an Allocated Pension of $110,000 paying a minimum income of $6,000 per annum.

In addition to the $17,500 per annum from the pensions, they also received approximately $12,500 combined in age pensions. This is a total retirement income of $30,000 per annum (hardly the big end of town). The income streams were purchased from a life company and retail fund manager. Outside of these assets, they owned their home, car, $10,000 in the bank and some shares gained ‘free’ in a demutualisation.

In October 2003, at age 68, Mr L was diagnosed with a terminal disease as a result of being exposed to asbestos while working in sugar mills. He received a $300,000 compensation payment and was not expected to live much past Xmas. This would cut him off the age pension.

Mr L decided to commence an SMSF with $200,000 in his wife's name and they commenced a lifetime complying pension. A major factor in this decision was that Mr L did not want to purchase an asset test exempt pension in his own name, with a life company that would keep the remaining capital on his death.

Options following SMSF reforms:

The asset-test exempt pension in the SMSF gave the client flexibility in planning for his family upon the client's death and also ensures that his family (not a life company) will receive any unused portion of the capital.

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