27th October 2004

The Hon. Mal Brough, MP
Minister for Revenue and Assistant Treasurer
Parliament House
Canberra ACT 2600

Dear Mr Brough

Submission: Review into DIY Superannuation

The Taxation Institute of Australia ('TIA') opposes the changes announced in the 12 May 2004 Federal Budget impacting on defined benefit pensions ('DBP'). The TIA believes that the *Superannuation Industry (Supervision) Amendment Regulations (2004) No. 2* ('SIS Amendment Regulations') should be withdrawn as soon as practicable.

The TIA notes that the Senate Economics Legislation Committee report dated 30 August 2004 recommends that after the Government's announced Review is finalised, new regulations should be drafted that 'allow self managed superannuation funds adequate flexibility to provide a range of pensions but which also more acutely target any potential abuse'.

In particular, the TIA finds the following matters of greatest concern in relation to the SIS Amendment Regulations:

- They have retrospective effect given that superannuation benefits are 'preserved' and superannuation is a long-term savings vehicle;
- Failure to solve the perceived problems, eg, RBL compression;
- Discriminatory – these new rules allow those in funds with 50 or more members to obtain RBL compression;
- There has been a lack of consultation with industry; and
- The changes are creating an environment of mistrust in many from investing further money into superannuation where there are ongoing ad hoc changes.

Further, the TIA believes that it is grossly unfair to retain the 20 September cut-off date for the availability of the 100% assets test exemption for complying lifetime and life expectancy pensions.

The gazettal of the SIS Amendment Regulations, the subsequent issue of further transitional relief, the Senate Review of the SIS Amendment Regulations and the announcement of the election has placed further uncertainty on the timing and

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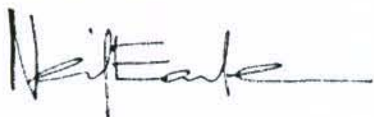
resolution of any review of the regulations. This has resulted in an environment of great uncertainty, confusion and inability for clients and their advisers to take any action.

This is a disgraceful example of Government change where no real transitioning has been provided. In short the Government has created enormous uncertainty in the superannuation industry. Accordingly, the cut-off date should be extended to at least 20 September 2005. The TIA's reasoning on this issue is also outlined in the attached appendices.

The TIA's concerns are detailed in the attached appendices: Appendix A (Review into DIY Superannuation) and Appendix B (Taxation in Australia – journal article).
Should you require clarification of any of the matters contained in this submission, please do not hesitate to contact at first instance Michael Dirkis, Tax Director of the Taxation Institute on (02) 8223 0011.

Yours faithfully



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APPENDIX A: REVIEW INTO DIY SUPERANNUATION

The Taxation Institute of Australia ('TIA') welcomes the announcement on 5 August 2004 by the Minister for Revenue and Assistant Treasurer, Mal Brough, initiating the review into the provision of defined benefit pensions by DIY and other small superannuation funds ('Review').

The TIA opposes the changes as announced in the 12 May 2004 Federal Budget impacting defined benefit pensions ('DBP'). These changes have not been well orchestrated and do not prevent the very abuse they were aimed at. The TIA urges Treasury and the Government to rethink its position and to review it in light of the following material, which outlines the problems occasioned by regulation 9.2B *Superannuation Industry (Supervision) Regulations 1994* (Cth) ('SISR') followed by our recommendations for alternative reform measures.

These recommendations are formulated with a view to rectifying more effectively the perceived mischief whilst ensuring a practical and viable solution is developed that encourages continued confidence in superannuation as a long-term retirement savings vehicle.

Problems with regulation 9.2B SISR

New regulation 9.2B SISR will, among other things, effectively restrict the payment of certain types of income streams to superannuation funds with more than 50 members and to annuity providers, ie, insurance companies. Effectively, this measure will preclude most self managed superannuation funds ('SMSFs') from providing DBPs to their members.

We understand that a significant driver for the changes has been a perception that there was inappropriate use of these pensions — enabling individuals to obtain better than intended tax outcomes either for themselves or their dependants.

We are not aware of widespread abuse of the DBP system by SMSFs and would be interested in seeing any research or evidence relied on by the government in this regard.

In our experience, a typical taxpayer drawing a DBP from their SMSF has put part of this into a DBP for two reasons:

(i) to access their pension Reasonable Benefit Limit without being forced to divert large parts of their superannuation savings to annuity providers. This is perhaps not surprising given that annuity providers are typically the large financial institutions with expensive fee structures that have not necessarily produced any value when it comes to investment performance. Indeed, yield factors quoted on such annuity products have been very low;

(ii) to ensure that their overall retirement income stream package includes a pension that is genuinely designed to provide an orderly draw down of capital over a period relevant for them (eg, their lifetime and the lifetime of their spouse) — with all the protection, security and stability this entails.

One important factor has been the knowledge that the income stream is fixed and is designed to last for the pensioner's lifetime. Statistics are such that around 50% of people will outlive their life expectancy and a life expectancy complying pension may leave them with no income stream beyond that period.

In other words, DBPs from SMSFs are used as part of a sound retirement package by financially responsible and self-funded retirees. We expect that prohibiting them from using this structure will simply mean they make less use of the superannuation system or draw less appropriate income streams, potentially leading to greater reliance on the social security system. It will not encourage retirees to make greater use of annuity providers.

For example, if people have the confidence that upon their death, their superannuation savings will pass to their dependants, then they are less inclined to worry about what happens after they die. However, where the only option is that a life company is to benefit from their premature death, then they are reluctant to accumulate towards that goal.

By way of example, the TIA is aware that many of its members who have advised on DBPs from government and employer funds in the typical situation as follows:

Facts: There is dad and mum and two or three children. Dad is offered a pension for life from his employer's fund (a Government or Employer-Sponsor fund) and on his death his wife is entitled to two-thirds dad's pension. The pension is indexed and has no residual capital value. The implicit yield and security of this pension is, on first glance very attractive, as the Government or employer must underwrite the investment risk. The amount and terms of the pension that has been promised is very attractive and may be difficult to replicate in the commercial market place. However, the attractiveness of this type of pension all depends on future events. In particular, the TIA is aware of many advisers who point out that if mum predeceases dad or worse still, mum and dad die together, that they could be significantly worse off compared to an accumulation fund where at least some moneys would pass to the children. Thus, having a guaranteed pension stream or DBP is only one part of the story. The actual term of the pensioner's life expectancy and that of the reversionary beneficiary's, if any, is critical to determine whether a DBP will be 'in the money' for the family.

The TIA is very concerned that if new regulation 9.2B SISR remains law, that there may be the potential for abuse and the recent proposed changes are clearly not designed to prevent such abuse. Regulation 9.2B SISR is an inappropriate solution for several reasons.

One thing that should be addressed immediately if there is any abuse is to close-off the abuse that can now only be affected by funds with greater than 50 members. The TIA understands that typically the funds that now legitimately allow for the abuse mainly comprise funds for corporate executives, politicians, judges and senior public servants. Equity and fairness dictates that these members should be subject to the same rules that apply to members of SMSFs. There is no justification at all for restricting regulation 9.2B SISR to SMSFs assuming this regulation is to remain. If it is considered politically risky to apply regulation 9.2B to these other members, then the

Government has overlooked the political sensitivity of those who constitute SMSF members.

In particular, the Government is likely to significantly impact people in regional and country areas who would have obtained the benefit of 100% assets test exempt pensions prior to the introduction of the growth pension on 20 September 2004 when the assets test exemption phases down to 50%.

It is also worth noting that the proposals on growth pensions will not meet the needs of all Australian superannuants who were looking to take a 'complying' pension from their SMSF. A growth pension (even where the pensioner has chosen to use a life expectancy 5 years longer than his or her own) is not guaranteed to last for a lifetime and may fluctuate unpredictably from one year to the next depending on the pensioner's account balance at the end of the financial year. Pensioners who would like the comfort of a more predictable income stream may be reluctant to take a growth pension as it does not meet that type of person's needs.

Alternative options for reform

If there has been any potential avenues for abuse in relation to DBPs by SMSFs, these should be able to be addressed more effectively by using less draconian measures than an outright prohibition. Suggested alternative options for reform for any perceived abuse are set out below:

Avenue 1

Avenue for abuse: Quarantining funds from the Reasonable Benefit Limit ('RBL') system

One potential avenue for abuse which has been identified is that the funds set aside to provide a DBP in an SMSF are inevitably higher than the value placed on that pension for RBL purposes — allowing taxpayers to have only part of their balance assessed against the applicable RBL.

Potential solution: Update Pension Valuation Factors ('PVFs').

One of the reasons the difference arises is because the RBL value of most DBPs is based on a formula. The factors used in the formula calculation ('PVFs') generally result in some undervaluation of the pensions - largely because they were derived many years ago under quite different economic conditions (eg, they assume long-term investment returns of more than 10% pa and inflation of 7% pa). One simple solution would therefore be to update the factors to more appropriately value today's pensions.

As well as a simple recalculation based on more relevant assumptions, the following should be addressed:

(i) the current factors make very limited allowances for the provision of reversionary pensions (eg, ongoing pensions to the original pensioner's

spouse). Most importantly, the factors make no allowance for the age of the reversionary pensioner even though this has an extremely material impact on the value/cost of that pension. Similarly, the formula makes only an approximate allowance for the size of the reversionary pension;

(ii) the factors are grouped in 5 year age bands rather than ***providing*** for individual ages;

(iii) the factors are not sufficiently dynamic to cope with changes in economic conditions (eg, a pension indexed to inflation will cost far more to provide when inflation is running at 7% pa than 3% pa — unless there is also a corresponding change in the expected long-term return of the fund).

These issues have been addressed in the determination of appropriate factors for 'splitting' superannuation entitlements under the *Family Law Act 1975* (Cth) — presumably the same approach could be adopted for RBL calculations.

Note that updating and redefining the PVFs would give a more equitable result than simply basing the RBL value on the 'purchase price' of the pension.

These changes would at least ensure some proximity between the RBL value of the pension and a genuine 'best estimate' of the amount required in order to finance that pension. This 'best estimate' figure is a key component of the actuarial assessment of the total balance needed to fund the pension.

There would still be some difference between the RBL value and initial capital sum applied to provide the pension. This is because solvency tests set out in the *Superannuation Industry (Supervision) Act 1993* (Cth) and SISR effectively encourage pensioners to set aside more than the actuary's 'best estimate' of the liability imposed by the DBP. The excess (referred to as the 'solvency reserves' in this letter) would remain quarantined from the RBL system. However, before concluding that this gives rise to any abuse for pensioners, it is worth bearing in mind that:

(i) if the fund's experience exactly matches the actuary's assumptions (ie, investment returns, pension increases and mortality are exactly as expected), the solvency reserves will not be required in order to meet the pension payments. They will instead be 'left behind' once the pension ceases. While that event in itself gives rise to a further RBL planning opportunity (discussed below) it is noteworthy that if the solvency reserves are never actually reflected in the benefit received by the pensioner (ie, they are just there in case the fund's experience does not match expectations), it is entirely appropriate to exclude them from the pensioner's RBL assessment;

(ii) under current ATO rulings, investment earnings on these solvency reserves are taxable at the normal superannuation rate of 15% rather than benefiting from the zero tax rate typically applicable to pension funds. Accordingly, the Government is not providing concessional treatment to the solvency reserves that are obtained from the pension assets themselves.

Avenue 2

Avenue for abuse: leaving reserves to dependants

We understand that a second concern with the provision of DBPs from SMSFs is the ability of taxpayers to tax effectively pass on significant parts of their superannuation balances to their dependants. This may arise under a variety of circumstances, such as:

(i) taxpayers could deliberately 'overfund' their DBPs (i.e., put far too much capital aside to fund a given pension) with the intention of leaving these reserves to future members of their SMSF (i.e., generally dependants). A similar result is achieved if the solvency reserves described above are not required; and

(ii) the fund's experience may be much 'better' (in an actuarial sense) than expected. For example, the pension may cease earlier than expected due to the premature death of the pensioner or the fund's investment returns may be greater than expected. In effect, the fund makes a 'profit' as a result of the DBP.

Before concluding that this is necessarily a significant problem, it is worth bearing in mind that:

(i) the same scope for unexpected profits due to premature death exists with an annuity contract. The difference is simply that the windfall passes to the insurance company rather than remaining with the pensioner's family. The example illustrated above, clearly illustrates that there is nothing at all wrong, immoral or unlawful about leaving such funds to a member's dependants. This is consistent with the Government's need for families to be self-sufficient and self-funded and assists orphans who may otherwise become a responsibility of the Government;

(ii) our discussions with a number of actuaries actively practising in this area indicate that the annual income provided from a DBP within an SMSF is broadly comparable (or in fact generally a little higher) than the income available under a commercial annuity. This suggests that far from artificially suppressing the income drawn from a superannuation balance, DBPs paid from SMSFs at least match (or even exceed) annuities. Paradoxically, driving taxpayers towards commercial annuities may actually reduce tax revenue and simply enhance life office profits;

(iii) any balance 'left behind' after the completion of the pension are generally allocated to other members of the fund and then assessed against their RBL when received as a benefit. The moneys do not, therefore, necessarily 'escape' the RBL environment entirely. Importantly, we believe that in most cases, there is little benefit to the taxpayer in deliberately structuring their affairs to build up excessive reserves. They will simply be passing an RBL problem from one generation to another.

Potential solutions

Potential solutions include:

(i) addressing weaknesses in the current tax legislation which enable some of the 'left-over' reserves to be distributed to beneficiaries at minimal tax; and

(ii) applying more incentives to ensure that DBPs ***do*** not 'over fund' as any reserves 'released' on the completion of the pension must be applied towards the pension payable to the reversionary beneficiaries or paid out as a lump sum benefit. Note, due to the risk of both the pensioner and reversionary beneficiaries predeceasing their life expectancies, this issue can never be resolved in a perfect manner; there will always be some reserves that will need to be dealt with. The TIA considers that the most effective method is that any reserves eventually end up for the benefit of the dependants.

Timing

Regardless of the appropriateness or otherwise of the proposed changes, we have several concerns about the way in which they have been introduced and their timing:

(i) Retrospectivity

If the SISR remain in their current form, they will have a substantial impact on taxpayers who have already made significant progress towards saving for their retirement — forcing many to completely re-think their plans in an extremely uncertain environment. However, many do not have much option at all as they now have far more limited options available to them as compared to the pre-12 May 2004.

Australian lawmakers have historically taken great care to avoid such unfair retrospectivity. When the Reasonable Benefit Limit regime, for instance, was last updated in 1994 to standard dollar limits of a $400,000 lump sum and a $800,000 pension RBL, special transitional rules were put in place for any taxpayer who had already built up larger superannuation balances or who were close to retirement and could obtain the benefit of the prior formula of calculating their RBL having regard to their salary levels.

The proposed changes do not incorporate any similar protection for:

a. individuals who have built up substantial balances in their SMSFs but have not yet retired and converted these to an income stream. Assuming the SISRs are to remain, these persons should not be adversely impacted and should be granted relief; or

b. individuals who have already accumulated superannuation assets in excess of their lump sum RBL in another superannuation vehicle (eg, a corporate fund, public offer fund or public sector fund) and intended to establish a complying lifetime pension within an SMSF once they had already retired.

The TIA also submit that transitional relief should cover those with membership in SMSFs as of 12 May 2004 (or such later date if the start date is to be deferred). This would mean that any SMSF member on that date would, regardless of what was in their trust deed or whether an actuarial certificate or whatever was obtained on Budget night (ie, a matter of sheer luck), obtain transitional relief. To require any less is inequitable, unfair and arbitrary as many who should have been better placed will not be depending on factors that equate to a 'roll of the dice at the casino'.

(ii) Effective Date

The new growth pensions start on 20 September 2004 but the DBP changes are effective from 12 May 2004. This is an extremely unsatisfactory method for the Government to stop the expected 'stampede' of those who may have acted before 20 September 2004 to obtain assets test exempt pensions. Until the 25 June 2004 transitional relief was released, the SISR prohibited every pension option other than a allocated pension in an SMSF. This was a very arbitrary and inequitable method of tackling this issue. To expect members to roll-over their moneys to life companies to obtain a DBP which is 100% assets test exempt is unrealistic. This signal will send to all concerned that the Government's rhetoric and vision for many years has been to encourage pension streams (to offset its social security expense) is now discouraging the best form of accumulation for retirement as people are not happy gambling at the casino, ie, if mum and dad both die in an accident, then the life insurance company wins!

The lack of flexibility in the transitional rules and the lack of any real choice create an impossible situation for those starting their income streams in the short-term and those planning what to do in the long-term. They have no viable alternative but to consider a commercial annuity provider if they like to gamble their future family nest-egg away or they can bide their time until the growth pension becomes law.

There are many however who have already attained a compulsory cashing requirement and who may now be technically in breach of the SISR as they cannot start their desired pension and are obtaining advice. Many advisers are taking a 'wait until the dust settles' approach as the Governments announcements have been very unclear - some further transitional relief may be forthcoming but the Government inquiry will not report until April 2005.

Certainly, further transitional relief must issue to overcome these problems. The expensive advice and costs associated with changing strategy should be allowed as a special tax deduction. Restructure relief and an exit from the super system should be allowed if the Government wishes to persist with the current regulation 9.2B SISR. People who have accumulated in the faith that they could take a DBP only to find now that they cannot should not be entrapped by Government promises where the 'wool is now pulled from under them'.

Conclusions

Unfortunately, it would appear that the SISRs introducing the changes have been tabled with no prior industry consultation, giving little opportunity to find more effective ways of achieving the Government's objectives.

Had the approach been different, it may have been possible to achieve a far better outcome for Government, taxpayers and the community generally. The TIA is particularly annoyed that proper consultation has not occurred on this matter as this is one area where the TIA members are very involved with the day to day advising of many SMSFs.

As discussed, if there was any abuse, what evidence has been put forward supporting such a substantial change to the Government's retirement income policy that has arbitrary and inequity stamped throughout. There will be many who will be adversely impacted by the changes and

the Government is likely to be a major one as the incentive to accumulate for a proper lifetime pension that suits many families is now in jeopardy.

The current situation benefits only life insurance companies and reduces choice and equity for those members of the community who do not wish to use financial institution's to assist with the retirement planning where a member's death may add to the profits of that institution.

It is also worth noting that there is very little competition within the Australian annuity market place as there are relatively few players. This means that commercial products are expensive and product design is unhelpful to the annuitant.

Furthermore, the size of an institution does nothing to prevent collapses as recent partial failures of several life insurance companies in the UK and elsewhere has indicated. However, where a large institution fails, the damage to the broader community is far greater. In any event, the TIA is of the understanding that life insurance companies are unlikely to enter the market place offering product that will offer much attraction to the consumer.

It is understood that the life companies and financial institutions are more attracted by the account based growth and allocated pension where the risks are more readily ascertainable. Accordingly, the Government should rethink its position with the view to removing regulation 9.2B SISR and actively encourage taxpayers to save for a life-time pension.

APPENDIX B: TAXATION IN AUSTRALIA JOURNAL ARTICLE

Attached is an article recently published in the Taxation Institute of Australia's ('TIA') journal 'Taxation in Australia', which outlines the many issues and problems in relation to the proposed changes to the SISR. In particular, the problems highlighted by this article are:

- The issue of the perceived abuses in relation to the strategy of 'RBL compression' has not been resolved as members of large superannuation funds are still able to take advantage of them. It is submitted that preventing members of small superannuation funds from undertaking this strategy does not solve the problem, and creates an inequitable outcome that is perceived by many as keeping this unique strategy available only to members in funds with 50 or more members that provide DBPs.

- The issues of mortality risk and estate planning are major concerns for many people who do not wish to risk assets. Certainly, from an estate planning perspective, the ability to ensure that assets are not lost as a result of the premature death of one or both spouses would encourage retirees to commence lifetime income streams and in so doing, be more likely to be able to be self-funded in retirement. Such a shortcoming, which is inherent in income streams purchased from large funds and life insurance offices, is a major deterrent to people establishing lifetime income streams.

  It is submitted that revising the pension valuation factors for life-time pensions to overcome RBL compression, would be a far more appropriate approach.

- The ability to establish a DBP to obtain social security benefits has already largely been resolved by the amendment to social security legislation reducing the exemption from 100% to 50%.

- The 12 May 2004 Transitional Relief ('TR') will benefit very few people, as the regulatory view is very narrow and in some respected commentators views untenable. To require documents giving effect to a DBP to be in existence prior to 12 May 2004, such as actuarial certificates, trustee resolutions, etc, is not only excessive, but contrary to respected legal opinion, which states that the prohibition will apply to funds 'the governing rules of which are amended after 11 May 2004 to provide for the payment of a DBP'. Such documentation, it is submitted, is not part of the 'governing rules' as defined in the *Superannuation Industry (Supervision) Act 1993* (Cth) and SISR, but is merely documentation to enable the operation of the pension.

- There are contradictory signals from the regulators as, based on the above interpretation, an amendment to an existing pension (eg, a different indexation rate or a different reversionary pensioner) would represent an amendment to the 'governing rules', thereby preventing the fund from paying a DBP. Consequently, this pension would need to be commuted and a new pension commenced in a superannuation fund that can pay a DBP, and hence incurring fees. However, the ATO has stated that the new rules are not intended to apply to DBPs already in existence.

  It is also unfair that if the terms of the original pension permitted an internal rollover and re-commencement of the DBP, when required by the actuary in order to meet the fund's statutory solvency requirements, that this would be treated as a fresh pension.

- There is ambiguity in the 25 June 2004 TR, as the SISR requires that a member become 'entitled' to receive a DBP between 11 May and 25 June 2004. A person becomes entitled to receive superannuation benefits usually when they satisfy a condition of release (retirement, age 65, etc). However, if this occurred before 11 May 2004, would they be entitled to the TR? While the interpretation evidenced by the ATO would indicate that they would, it is not an accurate reflection of the legislation.

  In addition, this TR is only available to people who were members of a small fund (fewer than 50 members) on 11 May 2004 and retire (as defined in SISA and SISR) prior to 30th June 2005. It does not permit someone who has unrestricted unpreserved money within an SMSF but who has not yet retired (as defined in SISA and SISR) to take a defined benefit income stream. Further, it does not cover someone who intended to set up an SMSF.

- There appears to be a potential application of Division 9.2A SISR on top of Division 9.2B as the payment of a DBP by an SMSF may result in the fund becoming a defined benefit fund due to the application of Division 9.2A. Many SMSFs pay DBPs from reserves, which in essence are a pooling of contributions, and accordingly, the TR envisaged by the 12 May 2004 changes rule out, on a technical basis, any transitional relief unless the fund in question has greater than 50 members because of Division 9.2B. Thus, the only basis that transitional relief under Division 9.2B could apply, it would seem, is where all the assets funding the pension were paid from an account balance rather than from the pension reserves (eg, pooled contributions and other amounts).

While it is conceded that RBL compression may provide some a tax benefit, a more structured, consistent, and considered approach could have been obtained that is equitable across all funds and will not be seen as favouring those with a vested interest. The law should enable DBPs to be undertaken as these assist the Government's long-term retirement incomes policy. The lack of empirical evidence as to these abuses is also a concern, as this raises questions about the justification for these measures.