John M Brett Consulting Actuary

9 March 2005

INTRODUCTION

As I read through all of the previous submissions from other parties, I was inspired by the strength and cogency of some of the arguments advanced. However, I saw some areas in which I felt input from me would assist. It is these which I am modestly attempting to address here. Along with my working Summary of these previous submissions, I also attach a previous submission I made in December 2004 on the Treasury paper titled “Transition To Retirement” which should be addressed simultaneously with the issues involved with this review.

I am involved daily with the area of lifetime pensions and would be pleased to provide any expansion/clarification which would further assist Treasury in their deliberations.

John M Brett
FIAA

SUMMARY

A. Lifetime pensions are better than the alternatives for **all of** the stakeholders
B. Actuarial control can be delivered using current legislative approved standards
C. RBL “compression” is logical.. it is **not** a “rort”.
D. The consequences of a ban will be undesirable for the stakeholders
E. Existing other current avenues for revenue “leakage” need to be addressed
F. How to introduce enabling legislation
G. How the actuary can assist

A Lifetime pensions are better than the alternatives for all of the stakeholders

<u>Pensioners:</u>

Workers accumulate usually regular, usually increasing income throughout their working lifetimes. They base their expenditure patterns around this. In retirement, a pensioner needs a regular, preferably increasing income stream payable until he dies.

I am not aware of another nation which has a history of lump sum superannuation or even the name “superannuation”.

Allocated pensions (AP) (and associated commutability) and the new Term Allocated Pensions (TAP) are hangovers from this lump sum philosophy.

The age pension is exactly the sort of lifetime indexed income stream that pensioners need in retirement. Why then is the government seriously proposing to ban individuals from providing their own retirement income streams in the same format?

Imagine designing an age pension payable for a fixed term! Or one where the year’s income drawings depended upon the state of the stock market on one day each year as is the case for TAPs!.

Lifetime pensions represent the best interests of pensioners and should be encouraged not banned.

In their submission numbered 14, the CPA makes the following very telling point which must **not be overlooked** by anyone with the brief of directing pensioners into one form of income stream compared to another:

The investment risk associated with a defined benefit pension within an SMSF is exactly the same as for a TAP or AP. Due to poor investment performance or decisions, the money may run out early. If anything the risk is less as the funding for a defined benefit is regular overseen by a qualified actuary.

Government Retirement Income Goals

Using legislative tools, the government's stated mandate is:

<1> to encourage individuals to provide for their own retirement.
As much as possible choice should be left to the individual and not prescribed. The same avenues should be available to those with SMSF super as well as those with large employer sponsored super.

<2> to minimise the drain on the public purse of doing so.

On current life tables, TAPs are at least 30% likely to run out before the pensioner or his spouse dies. With expected continued improvement in future mortality, and further exacerbated by the fact that those self selecting by being able to self fund their retirement are drawn from those with better than average mortality, one can foresee over 50% of TAPs pensioners depleting their TAP income before they die. Many will then fall back on the age pension.

<3>to encourage individuals to retain their link with the workforce as long as possible

In November 2004, the Government published a position paper addressing "Transition to Retirement". To summarise my December 2004 comments, lifetime income streams address all of the issues raised much better than either APs or TAPs. I argued that the pension population does not need yet another income stream variant.

I also argued strongly that **government initiatives must be integrated over all policy goals. It is illogical to be banning new lifetime income streams for perceived APRA issues if they best address encouraging work-force participation issues.**

Lifetime income streams are clearly better than either APs or TAPs at addressing these issues.

B Actuarial control can be delivered using current legislative approved standards

The Institute of Actuaries drafted its Guidance IAA Note 465- Statement of Opinion in December 2000 after lengthy consultation with the ATO. One can only assume that whatever appears in this Note fully reflects legislative approval and knowledge.

In designing lifetime income streams for my clients, I take note of paragraphs 16 and 17 in that Guidance Note relating to whether increases to pensions in course of payment are guaranteed or to be funded for.

Suppose the trustee wished to fund for 3% pa pension increases but not guarantee them.

Then every year, the actuary would assess the fund's ability to give the high probability statement in respect of the guaranteed pensions, not the funded-for pension. Only if the fund performed satisfactorily over the year would I recommend that the lifetime pension be increased by 3%.

I also take note of paragraphs 25 (b) and (c) and 26 in that Guidance Note regarding assets available to back the high probability guarantee. Any other pension assets allocated to the pensioner are available to back this guarantee.

So, I design a lifetime income stream with funded-for pension increases greater than those guaranteed and also with the lifetime income stream enjoying first recourse to all of the pensioner's pension assets, specifically any allocated pension assets.

With a reasonable initial AP/ lifetime pension split and a reasonable guarantee/funded-for pension increase choice, the chance of a SMSF lifetime income stream failing is extremely remote.

C RBL "compression" is logical, it is not a "rort"

This particular debate has attracted a lot of indignation and envy. But, what does it actually represent? And how many are "abusing" RBL compression at present.

The 15% rebate was designed to return to the pensioner the tax he had already paid throughout the accumulation period prior to retirement.

Suppose a pensioner is proposing to commence an income stream with an account value of $3 million.

This figure may have been derived from:

<1> Marginal rated taxed Undeducted Contributions of say $750,000
<2> 15% taxed Deducted contributions of say $1,000,000
<3> up to 15% taxed investment gains of say $1,000,000
<4> Untaxed as yet unrealised investment gains of $250,000

The only part of the $3 million which has not already born tax is the $250,000. In the late 1990's there was a proposal for this figure to be taxed. This proposal was withdrawn.

There is therefore an excellent case to be made that the entire income stream derived from the $3 million should be rebateable.

If "compression" achieves this aim, it should be retained. And if "compression" requires that an income stream has to be spread over a very long term to achieve this, this also is to be preferred compared to forcing dissipation over a shorter period.

It seems irrational to encourage individuals to self-fund for their own retirement but penalise them if they are too successful at doing so!

D The Consequences of a Ban

There is great confusion amongst intending pensioners about what they will be able to do with their retirement funds. A ban on the "best" alternative from a particular date will add to that confusion.

I summarise below some of the concerns which I have heard expressed by my clients and which is also widely expressed in a number of the other submissions as I have summarised.

- It will discourage individuals from self funding in case they do so too successfully.

- It will further encourage alternative wealth accumulation vehicles, including the family home. There is already an disproportionately high proportion of assets invested in residential real estate. Further encouragement is undesirable for both its socially divisive consequences between the have and have-nots, for its vulnerability to interest rates and also its diversion of national savings away from real "productive" investment.

- There will inevitably be legal challenges and messy grandfathering provisions consuming much government resources in addressing.

- There may be a political backlash from the government's natural constituency against rules discouraging them from providing for themselves and their dependants.

- There is already a perception that legislators are personally entirely insulated from and unsympathetic towards the interests of these self-funded retirees by virtue of legislators enjoying the benefits of large plan superannuation, traditionally of lifetime defined pensions, the very type of pension which is proposed to be made unavailable to self funded retirees.

- There is also a perception that much of the government agenda is being driven by groups with interests inimical to self funded retirees

- There is a perception that the agenda is being driven by the Life Offices whose own lifetime pension products, unattractive as they have always been, will be allowed to continue as the only way of accessing a lifetime income stream. Even the 20 September 2004 Age Pension cut-off did not drive lots into Life Office pensions. And nor has the take-up of TAP'S been anything like that planned for, despite unseemly government prompting on many occasions.

<u>Likely Pensioner Responses</u>

Before disabling lifetime pensions, Treasury should model who is their target. And also, if they are successful, what will be the response of the targets.

The first obvious response will be to retire early while they still can access a lifetime pension. How does this sit with the government goal of encouraging individuals to defer retirement?

The second obvious response is to channel savings outside of superannuation. Appendix 3 to my December 2004 submission presents a simple modelling of how such a response will actually reduce tax collected from the same income stream! These are discussed in more detail in my November 2004 paper.

E Existing other current avenues for revenue "leakage" need to be addressed

These are addressed in my November 2004 paper.

In summary, these include:

<1> Reverse mortgages which are becoming more popular and are becoming recognised as a means of getting an age pension.

<2> Recontribution strategy

<3> Saving tax by accessing income streams outside of superannuation.

To the extent that a ban fuels any of these measures, it will lead to a reduction and not an increase in revenue collections!

F How to introduce enabling legislation

Ways to implement a change

Introduce an outright ban (such as have been proposed for SMSF funds and lifetime income streams), use taxation incentives (such as the recontribution strategy and rebates) or use revenue incentives (such as exemption from assets test for the age pension).

In principle, incentives are preferable to bans particularly as drafting bans can open a Pandora's box of grandfathering anomalies.

How to draft legislation

Before drafting legislation it is logical to "road test" before drafting. Who is going to be affected. How many?. What is the likely revenue consequences of the outworking of any ban? How difficult and complicated will legislation need to be to give effect to any changes? Refer here to ATO SD2004D1 which represents a complex ATO "best effort" to implement the ban on lifetime pensions payable from SMSF super funds.

Principles to be followed in drafting

- leave as much choice to the individual as possible.
- be as simple and constant as possible
- don't unfairly favour one group of either pensioners or product providers
- encourage the same goals across various areas of government involvement e.g. Centrelink, ATO, Treasury

G How the actuary can assist

Lifetime pensions require actuarial control and exercise of actuarial judgment. We are trained to do so and through close control via our professional body are effective in exercise of that judgment.

Actuaries maintain professional independence from all of the other bodies involved in the retirement income industry.

A financial advisor can advise pensioners on investing their funds; an accountant advises on tax and return issues.

An actuary is the logical professional to be advising a pensioner on how to draw down his income stream in order for it to satisfy his needs over the rest of his lifetime.

Actuaries can actually assist government departments in processing retirement income streams; one idea which occurred would be to have the AGA set up a menu driven spreadsheet calculation subroutine calculating the amount of excluded assets in a lifetime income stream. This could be completed by the actuary and submitted annually on Centrelink's SA330 to Centrelink staff who would merely have to check the inputs before being able to advise the relevant dollar amount of excluded assets. This would be provided at little or no extra cost to the client and would relieve the AGA of the backlog of requests with which it currently deals. It would also implement a logical system where the amount of excluded assets, annually, and not just at commencement, was checked to see that it was not too high.

John M Brett **Consulting Actuary** **ABN 466 577 99179**
Level 2 18 Kings Park Road West Perth WA 6005 (ph) (08) 9 426 4630
PO Box 1203 West Perth WA 6872 (fax) (08) 9 426 4601 (email) jbrett@mawsongroup.com.au

Summary of points made by others in papers listed on the Treasury webpage. *ttp://dbpensionreview.treasury.gov.au/content/default.asp*

Introduction

SUMMARY OF OTHER SUBMISSIONS

My background is as a sole practitioner actuary who has been working for 28 years since qualifying with superannuation defined benefits. I currently provide actuarial certificates to around 250 allocated pension and over 100 lifetime pension clients.

I meet with many of my pensioner clients and also accountants and financial planners involved in advising their pensioner clients.

I don't want to elaborate upon many of concerns which have already been made eloquently in other submissions listed on the Treasury website. Rather I wish to address how to satisfy as many stakeholders as possible as simply as possible.

Before I completed my March 2005 submission I read all of the papers listed on the Treasury webpage. I prepared my own working Summary of many of the points made. The Summary below does not however purport to present all of the points made in all of the papers. I have been subjectively selective and included only those points which I feel advance the general arguments

However, it has generally been expressed in each of the writer's own words and to the extent that it represents points culled from a much larger pool of backgrounds than any one respondent represents, it adds value to your deliberations.

Paper 1

SMSF services investment in property..more suitable for long term and also for lifetime pension

Paper 2 Ken Korman..SMSF member

market linked income streams inadequate because: fixed term and not for life. Rate bears no relationship to living expenses

Paper 3 Ross Bray..SMSF pensioner

Accumulated savings throughout working lifetime on the understanding that all of these savings would be available on retirement as a tax-sheltered income stream. Compare to ongoing tax relief given to home buyers

Paper 4 AIR Whylla..retiree's organisation

Discrimination against members in <50 member funds
Favoured life offices who have continually charged high fees and produced poor returns..evidence is of growth in SMSF's over recent years

Paper 5 Lynne Dobson..anticipating self funded pension payable from SMSF..ill health retiree.

Unfair treatment vis a vis non-savers who are eligible for the age pension

Paper 6 Mr Lethbridge.

Saving for retirement has already accumulated > LS RBL on actuarial advice. Lobbying of life offices unreasonable..in particular by David Shirlow from Macquarie who “invented” TAP’s. TAP’s less flexible than AP’s but will not last the distance. Successful SMSF investors will be penalised by having to pay excess benefits tax..**having already paid tax during the accumulation period. The “concessions” which are now being threatened represent merely a return of the tax paid during the accumulation period! <my addition>.** 2005 cut off date encourages premature retirement. Consultation is less common with the fragmented SMSF industry than with the powerful, large life office lobby.

Paper 9 SAI Private

No need for amendments in the first place
Retrospectivity breaches trust law
Those purchasing life office complying pensions will end up costing the taxpayer more

SAI’s planning strategy is that:

<1> all income not required for current living expenses be directed into superannuation.
<2> people are best in charge of their own investments
<3> advising client base of 208 SMSF’s

Submission makes the point that most superannuitants with excess super have not been trying to take advantage of the system; they have been accidentally placed in a situation where they will lose out if they do not and will be victims if the system is changed

Disadvantaged compared to large pension funds

No history of retrospectivity with regard to previous changes to superannuation; this superannuation history comprises:

1988 to 1992, it was possible to contribute to 2 super funds and hence this also led to “excess’ amounts in super

With tax in and surcharge and tax out, what is a taxpayer getting from the system?

Grandfathering for those over 55 is necessary to prevent conflict with Trust Law

Taxpayers who are denied a complying lifetime pension will add more to the public purse by choosing an alternative. Any loss if there is any, will be just a deferral

Paper 10

If the entire community and government understood this issue, all would have SMSF pensions, with all the wealth passing through to their children. We would potentially end up with the majority of the next generation self-funded, and ineligible for social security benefits.
<How does this frustrate government revenue goals? ..my addition>

Approximately 80% of total medical expenses occur during the last five years of life, about the time AP’s and TAP’s are almost expired. Surely super pensions in current form help offset this problem.

Paper 11

Is the Market Linked Income Stream a takeover by the Government of all super funds like the Singapore Government System, OR is it AMP and others trying to shop free enterprise and small business controlling their own funds?.

There is no real explanation for the new complying system except that this new system will mean SMSF's will not have to pay an actuary for an annual report. **<There has been an extraordinarily bias from the government promoting TAP's ever since they were first announced in February 2004. Despite this, take-up has been very slow and hesitant. My addition>**

Paper 12

No evidence of extent of "rorting" provided by Treasury. More rorts exist for "branded" life office products. Eg exit fees

Input to the "Captive regulatory authorities" has been only from the "large end of town."

Rules ostensibly designed to reduce rorts actually reduce competition and discourage self investment

Why does DIY super flourish where DIY has become extinct in many areas, eg home brewing, and less common in say building your own house. Because of costs, rorts , lack of innovations and mis-selling!

Paper 13 Tax Payers Association of Australia

SMSF members establish DBPs within their own funds on the premise that reasonable asset allocations can support levels of pension that are comparable or exceed those offered through retail offerings from large superannuation funds, on a sustained long term basis. In other words the risk that they perceive of a drop in performance of their assets is not worth the reduction in income that the additional premium entails.

SMSF members make decisions based on the available options and for the most part this is based on sensible judgments about their future well being. They do not have designs on abusing the system but are intent on making sound judgments about the inherent values of the different product offerings. Many have come to the realization that a DBP via an SMSF is a rational response, arrived at after due consideration that has included assessments of greater member longevities.

SMSF trustees recognize that the spirit of defined benefit pensions (DBP)s necessitates a conservative asset allocation policy and a tacit understanding that members will forego potentially higher investment returns in exchange for greater stability of returns and an asset test exemption. There are risks associated with any action they take, but by forcing members to pay the higher cost of complying pensions from large superannuation funds or Life Offices it is only likely to dissuade many from using those products. Surely this outcome is not the real intention of the new initiative of government.

1. Estate planning issue

Whilst we concede that SMSFs should not be used as primary estate planning vehicles we do not believe that estate planning considerations should be given unnecessary weight in the committee's deliberations.

2. Assets test exemption reduction.

A further question that comes to mind is why the assets test exemption is being reduced from 100% to 50% for complying pensions for those of age pension age. The policy would seem to

be aimed at the "so called" wealthy to ensure that they cannot use lifetime income streams to claim social security benefits.

However the fact remains that currently, individual account balances for SMSF members on average do not even approach half the lump sum RBL. These members will no longer receive the full 100% assets test exemption. Equity considerations would demand that an absolute asset value limit would be preferable to a reduction by 50% in the assets test exemption. This has been recognised by the fact that existing complying assets test exempt income stream pre 20 September 2004 will continue to receive full asset test exemption.

Recommendation

The reduction in the assets test exemption from 100% to 50% cannot be justified particularly when considerations of equity are raised. We strongly recommend that the exemption should revert to the previous 100% figure.

3. Issues for retirement policy

The issues that retirees have raised in relation to retirement incomes policy include a preference that income streams provide a degree of certainty but also flexibility in meeting changing needs and the likely longer life expectancies and greater opportunities to fulfil retirement plans. The concept of on-going part-time work should also be catered for so that smaller amounts can be taken out of the superannuation system than is currently possible via an allocated pension for example.

Paper 14 CPA

By using a defined benefit pension a level of certainty can be achieved, with pensioners knowing how much they will receive and how long it will last, that is not possible with an allocated pension. The ability to put some aside for estate planning purposes is not unreasonable and is within the spirit and the letter of the superannuation legislation.

Investment risk

Investment risk should not be a consideration when deciding the appropriateness of SMSF's providing defined benefit pensions. **The investment risk associated with a defined benefit pension within an SMSF is exactly the same as for a TAP or AP. Due to poor investment performance or decisions, the money may run out early. If anything the risk is less as the funding for a defined benefit is regular overseen by a qualified actuary**. If individuals are willing to take this risk with their own money, they should be allowed to.

Paper 15 ASFA

RBL compression is available from large defined benefit funds!!

Over 50 member allowable funds..viability rests with strength of sponsor not the number of members

Paper 18 Actuarial Solutions

Life expectancies are lengthening quickly. Over the 5 years between censuses the life expectancies for retirees increased by about 1.25 to 1.5 years. This is an average of 0.25 years improvement for each year. If this is extrapolated current retirees with a life expectancy of 20 years could have on average an extra 5 years, or 25% longer in retirement.

Paper 19 Heffron Actuarial Consulting

Govt incentivises individuals to continue work and provide for own retirement. Lifetime pensions do not allow premature dissipation of assets through commutation. Recent government concern appears over not dissipating too slowly!

TAPS do not address the issue of market-proofing or outliving income stream. **However, choice between a lifetime purchased or a self funded TAP will lead to many choosing the "inferior" TAP. <my addition>**. Encouraging lifetime pensions from DIY funds will actually reduce the drain on social security

Actuarial concerns

"failure" only effects the individual fund.. large player "failure" will effect thousands

"failure" will result in a lower rate of future drawing. However, draconian social security consequences of "failure" are far more likely to induce "profligate" behaviour

"failure" is in fact more likely for AP's and TAP's as far as running out of income stream while still required. This point is made by a number of contributors and must not be overlooked! <my addition>

AGA identified 3 reasons for failure: longevity, investment underperformance (a matter of investment mix not number of accounts!) , illiquid assets (this last generally an issue for commutable income streams, not lifetime complying. Also less of an issue as an option for SMSF's is to draw payments in specie. Also family nature of SMSF's leads to incoming contributions from children.

Liquidity more likely to be an issue for TAP's with there being in total thrall to the market value on a particular day each year.

How many have failed? 1-2% further 2-3% restructure. However, with ATO 2004/SD1 removing ability for commutations. **If anyone can work with this ruling!!. <My addition>**

Estate Planning

Is it OK to have "surplus" assets over on the death of a pensioner pass to the shareholders of a public company but not to a pensioner's beneficiaries?

Submission 20 Price Waterhouse Coopers

UDC's have recently been encouraged by ATO ruling and hence, logically, their use in RBL compression encouraged!

Social Security access..already subject to the deprivation rules for "excess" amounts.

Could also address the income test and make it bight!!

AP's & TAP's are just as risky as DB's just as subject to investment failure..even more likely to suffer from longevity failure. **Members all bear the investment risk during accumulation, why not also in retirement?**

Over 50 member pension funds addresses the issue of averaging..not increased longevity in general!

Paper 21 B Rice Walker Actuaries Integration with retirement income policy

Very Relevant paper

Sets out the retirement income needs for the whole population

Age Pension does not provide for partial retirement

Presume government goal is for private superannuation eventually to replace the Age Pension for most Australians

Analysis that at June 2003, of those people > NRA, there were around 520,000 self funded retirees, 2,140,000 in receipt of full or part age pension and 92 000 in employment.

They state that pensioners appear to become more dependent upon the age pension as they age, implying that they spend their assets in the early years (37% of males at 65 down to 22% 6 years later)

Community focus should be on adequacy of income for retirement, however long that may be. This is definitely the case for the Age Pension

Need to integrate entitlement to age pension with part-time work before age 65.

Access to age pension should only be after all retirement assets are committed to be used over the pensioner's lifetime

Government should focus on measures to:

Improve targeting to those really in need
Eliminate anomalies
Encourage working longer

Age Pension offsets can be reduced by assessing all retirement income with an appropriate income test

Individuals to be offered the opportunity to purchase from the government the amount of Age Pension they are denied by reason of the means test

Double dipping..retirees spend their super (eg on home improvements) and then claim the age pension. Solution..make access to super benefits prior to 65 subject to purchasing the full age pension

Home Equity.. assess deemed income potentially available through effecting a reverse mortgage

Pension Bonus scheme per year deferred provides far less than age pension per year

Comment on introducing any imposts on youngest first, then progressively on those closer to retirement

Paper 22   FPA

A.   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.

B.   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.

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'.

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 [1]) and the objective is to provide a pension payment guaranteed for life.
- 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.
- It offers more flexibility to run a defined benefit pension for dependants such as handicapped / disabled children in the family. [2]

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 [3]
- 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 [4]
    - 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).

Market-linked pensions are <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:

1. The **certainty** of a predetermined income with the ability to nominate a level of indexation to help keep pace with inflation. [5]
2. The **flexibility** to choose between complying and 'non-complying' lifetime or life expectancy (fixed term) pensions. [6]

3.3 Reasonable Benefit Limits (RBLs)

---

[1] 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.

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

[3] 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.

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

[5] 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'.

[6] 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.

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 [7] However, as RBL assessment of these pensions has not been addressed, **there is still 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.

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.

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.

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**. There is no scope for the beneficiary to spend these amounts before meeting a condition of release (normally retirement.

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.

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 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.

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

---

[7] 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.

faster depletion of retirement capital and **greater reliance** on Government Income Support in the future – something no government wants!

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.[8] 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.

<Lot more FPA comment on trust deeds>

There are substantial legal compliance issues. 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 under the grandfathering arrangements.

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

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.

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.

John M Brett **Consulting Actuary** **ABN 466 577 99179**
Level 2 18 Kings Park Road West Perth WA 6005 (ph) (08) 9 426 4630
PO Box 1203 West Perth WA 6872 (fax) (08) 9 426 4601

10 December 2004

[8] 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.

December 2004 Comments on Transition to Retirement

Submission 2

This submission follows on from my initial submission dated 9 November and addresses the issue of how best to structure the retirement income streams .

(1) Introduction

Whatever is introduced must integrate legislative approaches across ATO/Centrelink/Treasury areas of control. Treasury should drive the agenda; it should represent the government vision of how to utilise incentives to encourage individuals to act in the national and their own best interests. Treasury should set down government intentions reflecting the broader issues such as lump sum vs income streams.

(2) Integration

Integration must look at the whole picture including current taxation and Centrelink concessions. Although not specifically sought in the Transition paper, my submission includes 4 brief appendices on the following topics.

APPENDIX 1 Reverse Mortgages
APPENDIX 2 Recontribution Strategy
APPENDIX 3 Responses to restricting 15% rebate/abolishing the RBL compression strategy
APPENDIX 4 Commutable lifetime incomes streams

If a piecemeal approach is taken to the Transition issue, the results will be continuing frustration of government objectives.

(3) Retirement Income Policy Objectives (RIPO)

These I have touched on in my first brief submission dated 9 November 2004.

However, they should be stated, debated and ultimately accepted before any legislation is drafted.

My RIPO's, taken from the Transition Paper, are as follows:

<1> provide flexibility in the rules for accessing superannuation benefits to encourage people to retain a connection with the workforce for a longer period.

<2> encourage savings to be drawn down in a regular and orderly way over the course of retirement.

<3> Although not stated explicitly in the Transition Paper, it is worth stating that significant revenue issues affected by aspects of RIP should be considered simultaneously.

(4) Retirement Income Stream Tools (RIST).

These comprise outright bans (such as have been proposed for SMSF funds and lifetime income streams), taxation incentives (such as the recontribution strategy and rebates) and revenue incentives (such as exemption from assets test for the age pension).

In principle, incentives are preferable to bans particularly as drafting bans can open a Pandora's box of grandfathering anomalies. An example of how convoluted bans are to

legislate is the draft ATO SD2004D1 which was published earlier this year as an ATO "best effort" to implement the ban on lifetime pensions payable from DIY super funds.

Issues for Consideration contained in the Transition Paper

1 Characteristics for the non-commutable income stream

The income stream should continue, at a defined level, for a pensioner's remaining lifetime!

This statement is intuitively obvious; it reflects pensioners' income needs and also current social security age pensions.

Imagine designing an age pension payable for a fixed term!! Or one where the year's income drawings depended upon the state of the stock market on one day each year as is the case for TAPs!

Any approximation, such as term allocated pensions (TAPs) or Life Expectancy pensions are second best. Standard allocated pensions are even more deficient.

Currently, there are 5 types of DIY income streams available, allocated pensions, term allocated pensions, life expectancy pensions, non commutable and commutable lifetime pensions.

The Transition Paper floats the idea of another allocated pension variant!. I suggest that there be only 3 choices of income streams, not 6! And that these 3 be utilized to cope with all retirement situations, including transition.

Allocated pensions grew from the unique-to-Australia lump sum history of retirement financial provision. Only to the extent that these represent an inalienable "right" of Australians to access to capital in retirement, can these be justified. The current concessions and restrictions for these should at best be maintained, not enhanced. They do not really have a place in transition arrangements or logical further retirement income stream strategy development.

TAPs as noted above, are a suboptimal retirement income stream. To the extent that they represent a non-commutable allocated pension option, however, they better reflect a vision for sensible revenue management and retirement provision.

Life Expectancy pensions are neither fish nor fowl. They do allow a regular income to emerge rather than leaving an income to emerge at an unpredictable rate and hence are better than TAPs. However, it is hard to justify two fixed term variants and as the government appears to be fully and zealously committed to TAPs at the expense of define pensions, life expectancy pensions could be withdrawn.

Lifetime pensions should be encouraged, both during transition and post working. Worryingly, they appear to be the prime target of government concern and the source of a crusade. In her 12 May 2004 announcement, the Assistant Treasurer announced legislation to remove the ability of DIY funds to provide these after 12 May 2004. Two main government concerns were cited:

(1) the inability of small funds to guarantee defined pensions.
(2) the "abuse" by certain high new worth individuals of taxation concession available under RBL "compression strategies".

I do not accept either of these as sufficient reason to remove the "best" sort of income stream from within the scope of DIY super funds. It would also appear illogical for one arm of Treasury to be pursuing the demise of the type of income stream which best suits the goals of another arm of Treasury.

As an actuary, I would welcome the opportunity of giving input into the review which was announced followed widespread stakeholder objections to this crusade.

Restrictions on Commutation

Quoting directly from the Transition Paper, revenue incentives should be used to encourage individuals to “draw down (savings) in a regular and orderly way over the course of retirement”. Rather than become more complicated, why not formulate a simple rule that the maximum amount of concessionally taxed retirement savings which can be accessed as other than a regular lifetime income stream be restricted to 50%.? This rule could apply throughout the working life as well as post retirement. From an observation of my own pension clients, over 90% comply with this already without any legislative requirement. This is an excellent example of “road testing” to see what is actually happening before legislating.

Tax and Social Security treatment

I agree with the paper. However, “road-test” first before legislating. And as stated above, less rather than more income stream variants!

2 Should a limit be set on the amount of superannuation benefits that can be accessed under the transition to retirement policy?

This is a significant issue. “Road testing” will I suggest lead to the conclusion that it is best dealt with by encouraging lifetime pensions and discouraging allocated pensions by appropriate concessions. Certainly, this is one area where the crusade noted above must be tempered with good policy in transition planning.

Should the payment rules for allocated pensions be modified for purposes of the transition to retirement measure?

*A “50% rule” as suggested above is simple and largely removes this as an item of concern.

What issues are there with setting a cap on the value of benefits that can be accessed under the (transition to retirement) policy?

See * above. Together with pensioners’ natural frugality, I believe that this would remove this as an item of concern.

3 Should only those people who are still working part-time be allowed to access the (transition to retirement) policy?

No!!.

Work tests are fraught with difficulties for legislating, enforcement, understanding and also equity. The accumulation of the means to fund retirement and the drawdown of these funds should be as unfettered as possible.

Should it be compulsory for superannuation funds to offer transition to retirement to their members?

This is a question of employment policy rather than superannuation policy. If an employer has an accommodating employment policy, superannuation policy could be accommodated either within the employers own fund or an individual employee’s DIY arrangements.

APPENDICES

1 Reverse Mortgages

Since the time of drafting my 9 November submission, another very significant revenue draining strategy has come to my attention. This strategy is to put all of one's retirement assets into the owner occupied family home and then to access equity in this home by a reverse mortgage. This has huge potential to increase the drain on the public purse and hence should be addressed as part of RIPO 3 above.

The particular example which I encountered was a 65 yo with $600,000 in super, income needs of $50,000 pa and with a current home worth $600,000.

What this pensioner proposed to do was to sell his house, and buy one worth $1,200,000 to live in.

He and his 63 yo wife would then be eligible for the full age pension and they would access the balance of the $50,000 pa by means of a reverse mortgage on his $1,200,000 home.

I did some projections assuming that:

<1> the home, the age pension and his required income needs escalated at 4% pa compound.

<2> interest on the loan compounded at 9% pa compound.

On these projections, after 23 years (the longer of his and his wife's current expected lifetime) he would still have a small equity (around 10% in the then value of his home of $3 million) and he and his wife would have paid no income tax and further would have received 23 years worth of full age pension.

Obviously different assumptions would produce different results. However, these were the assumptions which the pensioner was happy with to plan his retirement!

And even if the future conspired to allow him to do so for less then the 23 years above, for every one of those years he was able to follow this strategy he would be in receipt of the full age pension and would pay no income tax!

My concern that is by being scrupulously vigilant with retirement income streams and unconcerned with the above strategy, the government may find itself with massive unsustainable revenue drain.

APPENDIX 2

Recontribution Strategy

This is used to describe the strategy of cashing in one's super to the level of the tax-free limit (currently $123,808) and then recontributing as an undeducted contribution to commence an income stream.

Only several months ago, this strategy, which has previously always been subject to ATO overview and tacit disapproval, was given the green light by the ATO. I suggest that Treasury should have done some revenue loss modeling before the ATO gave the green light to this strategy.

Consider the following simple example:

Pensioner aged 65; ETP=$1,000,000..assumed no Undeducted Contributions

Commences an income stream, first year's drawings $70,000 (mix of Term Allocated Pension and Allocated Pension)

Normal tax =$18,612
(Less rebate) =$10,500

Net income =$61,888

Suppose he cashes $123,000 of post 83 superannaution; pays no tax; and then recontributes as Undeducted Contributions

Still draws $70,000

Annual deductible amount =123,000/16.21 = $7,588
Taxable income =70,000 -7,588 = $62,412
Normal tax =$15,425
(Less rebate) =$9,363

Net income =$63,938

Reduction in **annual tax** paid by means of using this recontribution strategy = $63,938-$61,888 =$2,050.

Treasury should be able to model the cost of forgoing this revenue over the millions of future retirees who should now be receiving advice to proceed in this way.

APPENDIX 3

Responses to restricting 15% rebate

Treasury should consider the following possible response of high net worth individuals to preventing them access to the 15% tax rebate on the full income stream payable from a SMSF fund.

Current superannuation situation:

Client draws $150,000 from a fully rebateable income stream.
Gross income =$150,000
Normal income tax =$56,215
15% rebate =$22,500

Net income =$116,285; net tax paid $33,715

After abolishing the RBL compression strategy "rort" say 50% rebateable

Gross income =$150,000
Normal income tax =$56,215
50% of 15% rebate =$11,250

Net income = $105,035; net tax paid $44,965

Suppose as an alternative to holding assets in super and paying an income stream from the super fund, the client generates $150,000 of capital gains in his own name outside of his superannuation. Suppose that is all in respect of assets held longer than 12 months.

Gross income	=$150,000
50% exemption	=$75,000
tax on $75,000	=$20,962
Net income	=$129,038 ; net tax paid $20,962

This simple example illustrates that the 15% rebate is already less generous than the 50% capital gains offset. Reducing that rebate will just make it even more attractive to generate capital gains outside of superannuation. It is conceivable that the intended goal of “stopping tax abuse” will lead to the high net worth individuals paying even less tax than they would if they stayed in super and benefited from the “tax abuse”.

Both of the above two situations are realistic portrayals of the “top end of town” that the Government purports to be targeting for tax abuses; the consequences of both initiatives are likely to be reduced taxation payable by the “top end” individuals.

APPENDIX 4

Commutable defined income streams

These currently operate under SIS Regulations 1.06(6). A (possibly unintended) consequence of ATO draft 2004D1 is that these would no longer be usable to frustrate revenue concessions. This is because the ATO draft would effectively quarantine any assets remaining after commutation in a taxable sub fund. However, it is an appropriate time for government direction as to whether these should continue to be allowed in future at all, if it is considered that they do not coincide with RIPO (2) above.