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superfund administrators

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Superannuation, Retirement and Savings Division
The Treasury
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Dear Sir/Madam

Review of the provision of pensions in small superannuation funds
Response to Treasury discussion paper (January 2005)

Thank you for the opportunity to respond to the review of pensions in small superannuation funds.

Attached to this document are the previous submissions made to which I refer in this letter.

It was disappointing to see the review did not take to account many of the initiative and discussion items put to the Senate Hearing or from the following submissions. There seem to be some misunderstanding as to the operational management of a number of items as part of the review document. Whilst previous submissions address many of these issues I will address them in reference to the review paper.

Choice – 4.2

The introduction of market linked pensions which are solely non commutable as a supposed replacement of complying pensions goes no way to addressing choice. The unavailability of a commutable form of pension which covers both the primary beneficiary and spouse leaves no choice at all. The allocated pension calculation relates directly to the primary beneficiaries lifetime and pays no heed to the issues related to payments not meeting income needs.

The removal of Defined Benefit pensions, both a commutable form (under SIS Reg 1.06) and a non commutable form, (ie to allow access to the higher Pension RBL value) has effectively removed choice. The statement "Small superannuation funds can still offer allocated pensions and market linked pensions" as a choice seems to be a clear indictment of the single minded lack of choice which has been noted on many occasions by all other submissions bar the treasury itself.

The framework of providing a vehicle which encourages members to pay income streams rather than lump sums has been largely eroded by the removal of Defined Benefit Pensions (both lifetime and term certain)

It has been our experience that the use of defined benefit pensions increases with education of the availability of those pension types as they more correctly suited to the needs of individuals who are looking to smooth income streams and simplify the payments. That choice is now lost.

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Complexity – 4.3

The view on complexity seems to be unfounded. Once established, a defined benefit pension pays a simple non indexed or indexed income stream as compared to the market linked and allocated pensions which do not provide any clear view of what income will be from year to year. Further more each year to need to determine the value as at 30th June to determine the payments for the following year. Given the tax return is not due in until 16th May of the following year (as is the case this year), leaving 44 days in the year to determine what has to be paid. The propensity to error is substantial. It may well be very difficult to accurately calculate within sufficient time the correct payment. By paying an incorrect amount Centrelink entitlements can be automatically lost as too may be the Compliance Status of the fund.

Additionally, each year you need to determine if rounding up or down the life expectancy depending on when you started the pension.

A CPI linked pension requires an increase in payment in line with CPI. These figures for the ensuing year are announced before the end of the previous year.

To my mind the Defined Benefit pensions are much simpler to understand and ensure are correct than a market linked pension.

Inappropriate Access to tax concessions – 4.4

As has been previously stated, the people who inappropriately receive benefits to which they are not entitled to should be individually dealt with. It is difficult to comment on the estimated amount when the treasury has not published its figures in relation to this. It should however be noted that if the comments in points 4.4.1 & 2 are to be taken as the method used as the basis for the calculations then I question the validity of those calculation. It would seem that the review has not taken to account the fact that any amounts held in reserves are taxed at normal superannuation rates every year so that if a small pension is being drawn then a large component of the earnings of the fund will be taxed at full rates each year. Comments that imputation credits can be used to offset any tax payable (indicating by implication that this is some form of "tax avoidance") completely miss the point that dividend imputation was introduced to remove the previous system of inequality where dividend income was effectively taxed twice – once when the company earned it and once when the shareholder received it. This comment is implying that the government's dividend imputation policy is flawed.

Also overlooked is the fact that on death any amounts held in these reserves (that have been taxed each year) will create a new RBL calculation and will result in a likely excess benefit being generated and taxed.

Clearly these factors must result in questioning the estimates of revenue loss.

All submissions I have read agree that a more equitable formula or method of deriving the formula should be determined and applied.

Estate Planning - 4.4.2

It should be noted that the commencement of a pension to a beneficiary can only be reversionary to a SIS dependant of the primary recipient. To that end, unless a grandchild is a financial dependant of the primary recipient, then a "third" generation cannot receive the pension payment by way of reversion. This applies equally to an account based pension where the full capital balance on death is available to a SIS dependant beneficiary. Why should it be unacceptable that the residual amount of a defined benefit pension on death be available to beneficiaries in the same manner as an account based pension.

I note that no comment has been made about the ability for a death benefit ETP to be paid as an allocated pension or market linked pension after death to a SIS dependant. It seems it is OK for that dependant to receive the money by way of income stream after death from a death benefit ETP based on an account balance but when the same money is used to provide a defined benefit pension, apparently the value of that money or the audacity for a person to want it to be paid from their DIY fund to their family is somehow different.

Perhaps someone lost sight of the fact that the accumulated balance is one which the member themselves has accumulated as compared to an unfunded fund or an employer based defined benefit fund.

Further, the tax related of a defined benefit pension is likely to be greater as the reserve account pays tax as it goes along compared to an account based pension which does not. It can therefore be argued that a person with an account based pension who dies and leaves a death benefit ETP to a child (SIS dependant) (thereby retaining the benefit in a tax free environment) will result in significantly less tax being paid than a properly run lifetime pension reversionary to the same dependant.

The revenue cost due to "estate planning" also needs to be further explored, as it needs to be considered against the option of not using a superannuation fund. For example a person can purchase an asset in their own name, which does not have a yield (ie a block of land or a share which does not distribute dividends), hold that asset through their life and pass it to their children on their death. The revenue on that asset is Zero until the asset is sold. This is in fact worse (from an ongoing tax revenue point of view) than where a pension is paid from a fund and taxed annually in the recipient's hands with the assets held in reserves being taxed each year in the fund. It therefore can be argued that paying any form of pension is revenue positive.

Interesting what can be proved with figures. In the above example you could build a case for banning investment in non-income producing assets as it impacts tax revenue.

Key Issues 4.6.1

There is no such thing is any superannuation as a "guarantee". The risk of pooling amplifies the risk of poor investment choice across all involved in the fund. There are examples of the effect of this supposed pooling benefit, Occidental Life is a prime example where a significant number of people believed their funds were safe yet many lost a large amount of their retirement assets. If a large fund makes poor investment choices, thousands or hundreds of thousands of people are affected, Size on its own does not "guarantee" the members benefits.

If a single DIY fund invests poorly it is the sole responsibility of that fund. The effect does not extend beyond that fund. By definition this cannot affect more than 4 people with the overwhelming majority of SMSF funds only being comprised of husband and wife. The poor investments can only affect those who make the investment.

The SIS regulations already deal with how to deal with large reductions in asset values. A fund which cannot meet its liabilities must commute its pension and restart it at a lower level, bringing it back into line with the "high probability" percentage of the reserve.

Given that a fund must have an accountant or professional administrator complete the administration, an independent auditor review it and a professional actuary sign off on any pension aspects of the fund, the level of control necessary to ensure pensions can be overseen to ensure compliance, is already present. If the rules they are verifying are unsuitable, change them.

RBL Compression

Whilst it is noted that the current formula gives rise to compression, the review document fails to recognise that the amount not counted towards the RBL, plus any earnings on it, is held in a reserve. The reserve is taxed at normal superannuation rates and expenses of the fund are only

offset proportionally to the taxable component (ie if 25% of the fund is taxable then only 25% of the expenses are deductible). When the reserve is reallocated, either as a result of death or to a member account it is generally surchargeable, with the exception of those amounts so stipulated in ISR 1999/01 and becomes an RBL assessable amount to that account.

Much is said about a case where a $10 million capital sum manipulated the process to pay an extraordinarily low income stream which resulted in the RBL value being within the limit. Little is said about the future affects of that. A very large amount of that pension will be in the reserve account and will be taxable at normal superannuation rates. At the point it is paid from the fund or allocated it will be an excessive benefit. This would indicate that the amount on payment or re-allocation would at that time pay 47% tax plus it has paid tax on its earnings along the way in the reserve account. This alone should be a significant disincentive as the cumulative effect in the superfund plus the excess benefits tax is extraordinarily high.

It should be noted however that the formula is the cause of the result.

The requirement to put money to the reserve by its nature means that less capital is available to pay the pension. The compression reflects the proportion which is in the reserve as it will, albeit at a later stage, be RBL assessable on payment or re-allocation. Remember the allocated amount at the future date includes growth (ie not just the reserved capital from commencement)

The attached previous submissions, reflect the view that an update to the formula is required to ensure that it is fair and equitable for all parties (regardless of the 50 member rule). The compression applies as a result of the formula and not by any other means. Unless it is changed this compression effect applies to ***ANY*** lifetime pension. If the same $10 Million was taken to a life office to purchase the pension, the same formula and hence the same "compression" will continue to apply. The changes have not stopped this happening, they have just moved the place you can do it to a large fund, where such anomalies will be submerged amongst the thousands of members.

RBL calculation

The two considered options for changes to the RBL calculation refer to determining an account balance and assessing it at the time of commencement. This of course will only work for pensions which are purchased with a capital sum. An unfunded fund (ie government) has no capital by its nature so will need separate rules. Other defined benefit funds similarly do not have defined balances for individual members.

The update to the tables, refers to the SIS schedule 1B factors, which I agree should be updated to take account of specific ages, gender and reversion ages. This will go a long way to resolving the RBL compression issues. Additionally a table of mortality factors for determining the pension should be provided. In doing so a standard approach of pension based on growth asset parameters could be uniformly used. If this table was provided, there could be no argument that the pension being delivered was not appropriate to the supporting asset.

Reserve Management

A clear, non-surchargeable means of requiring reserves to be allocated to the participating member where the amount in reserve exceeds the amount required to meet the high probability rules should also be considered to ensure that assets do not overly build up in the reserve account.

Currently, money on which surcharge has already been paid, when including in the lifetime pension and forced to the reserve account as a result of the current formula is surchargeable again when allocated to a specific member. The provisions in ISR 1999/01 do not cover the ability to return a reserve to a specific member without surcharge. This seems to be counter intuitive. If the reserves became pension specific it would be easy to identify the reallocation to the member.

Key Questions – Residual Capital Value Pensions

An RCV pension is often used to keep a specific sum aside to pay for a significant event, such as a retirement home. In this way members can live on the earnings of the assets but know that funds are there specifically to pay for that purpose when needed. This is a comfort option that has been taken away. Allocated pensions cannot cater for this as by their nature capital is being paid out every year.

Consider a person who dies with young children (under 18), no longer can you pay a term certain pension to say age 25 then pay a lump sum. Do we really want a 12 year old to end up with a large sum of money on death? Not many parents would want that.

I believe RCV pensions play a significant role. I also recognise the reason why they are not more prevalent is that the general market place are not aware that they existed. When people are made aware they can see the benefits and do use them.

If the term of the pension was limited to a term equivalent to life expectancy of the primary beneficiary then it would satisfy most if not all needs of this pension type.

Pensions of this type are in high demand, when people are made aware they exist. The general knowledge about pensions and pension structures amongst accountants, financial advisers and fund members is poor which is why, traditionally, allocated pensions have been the pensions taken up by members. It is solely due to lack of knowledge that the other forms of pensions available have not been used.

Simplifying the wording in the regulations would go a long way to assist people to correctly make a choice between the various pension types.

Modify Existing Pensions – 5.3

Altering the market linked pension will not solve the issues for clients relating to lifetime needs and simplicity. The proposals made simply make this pension more complicated, not less and given that it is a clear intention that a simpler solution be found this goes directly against that.

Should this be the only option available, extending the term would be clearly required.

Adding a deferred annuity and expecting people to actually use it is difficult to imagine.

The current defined benefit pensions do all the things that these supposed modifications do, so the question is why bother, fix the formula!

We know that the older people are the more they will become risk averse. All the figures show this. The effect of having to take extra money out because the fund performed well in one year (such as this last one) only complicates saving and tax arrangements at a time when they are looking for simplicity. Having simple, smooth income streams is what most people seek. Throughout life people manage their affairs as a result of having regular income by way of salary. It is not difficult therefore to understand that people are seeking the same through their retirement. Neither market linked pensions nor allocated pensions provide for this.

Commutable Pensions

No discussion has been made of commutable forms of the various pensions. The review seems to be focused on the higher Pension RBL and non commutable forms of income streams. It is imperative you give people the same forms of pensions in commutable and non commutable form.

This will encourage people to keep money in the fund rather than take it out as a lump sum, knowing that it can be used to meet husband and wife lifetime needs but is available as a lump sum (using the lump sum RBL of course) in the event of an emergency.

Introduce New Pension Products – 5.4

Whilst I applaud the proposals to introduce new pension types, the ones proposed are not “new” they are the old ones with a modification. It does seem that a lot of time effort and money has been spent on trying to replicate in a different form what we already have, rather than simply dealing with the current formula and RBL issues. If the formulas are not changed, compression will still be available through life offices or any 50+ member fund, so all the changes, confusion and complexity will have been for nothing.

General

By correcting the inconsistencies in the formula, ensuring reserve amounts do not exceed high probability requirements, standardising the factors and simplifying the wording in the legislation to make it clear, all the issues raised can be dealt with without having to introduce a new range of pensions and forcing individuals to go back to life companies to have full access to the range of pensions available.

I am happy to make myself available for further comment.

Yours sincerely
Smartsuper Pty Limited

Andrew Bloore
Chief Executive Officer