29 March 2005

The Manager
Retirement Income and General Rules Unit
Superannuation, Retirement and Savings Division
The Treasury
Langton Crescent
PARKES ACT 2600

By e-mail to: **dbpensionreview@treasury.gov.au**

Dear Sir/Madam

Review of the Provision of Pensions in Small Superannuation Funds - Discussion Paper

SISFA welcomes the opportunity to respond to the abovementioned Discussion Paper released by The Treasury on 21 January 2005.

Introduction

At the outset, we wish to reaffirm our support for measures that seek to deal with the aggressive promotion or use of inappropriate tax minimisation and estate planning strategies involving small superannuation funds. However, we also must reiterate that Divisions 9.2A and 9.2B of the Superannuation Industry (Supervision) Regulations 1994, which purported to address such strategies associated with the provision of so-called "defined benefit pensions", ***are poorly targeted with grossly unjust consequences for small superannuation funds and their ability to pay pensions in the future.***

We remain of the firm view that the alternative solutions proposed in our previous submission (which, we note, are strongly supported in principle by the overwhelming majority of participants in this review and the earlier inquiry conducted by the Senate Economics Legislation Committee) will:

- address the key concerns of so-called "RBL compression" and estate planning; and
- at the same time restore the ability of small superannuation funds to have access to the full suite of pension options available under the SIS Regulations.

These solutions are discussed in more detail later.

The Discussion Paper

The Discussion Paper published by The Treasury is clearly a pivotal step in the review process and we welcome its release. However, the content or focus of the Paper is disappointingly misguided in our view and does not give adequate weight to

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the broad sentiments expressed in the majority of submissions made in the first round of the review.

Accordingly, the key themes in our original submission remain valid and reflect the **only** option presented in the Discussion Paper that we consider to have acceptable outcomes—namely, the retention (or restoration) of the ability of small superannuation funds to provide so-called defined benefit pensions but with appropriate modifications to:

- the RBL valuation of lifetime superannuation pensions; and
- the calculation of the initial annual draw-down amount for lifetime superannuation pensions.

This would also seem to be an outcome consistent with the recommendations of the Senate Economics Legislation Committee's Report on Superannuation Industry (Supervision) Amendment Regulations 2004 (No. 2) [Statutory Rules 2004 No. 84] published in August 2004 which relevantly provided on page 32:

> "2.124 Hence, the Committee believes that the regulations should not be disallowed but equally believes that they should apply only temporarily, until the Government's announced Review is finalised and further advice considered. ***The Committee recommends that, following the consideration, new regulations which allow self managed superannuation funds adequate flexibility to provide a range of pensions but which also more acutely target any potential abuse replace these regulations***."
>
> (Emphasis added).

The two other key issues identified in the Discussion Paper, namely social security concessions and risk, are no longer particularly relevant to this review in our opinion.

Inappropriate access to social security concessions has been adequately addressed by the changes to the means test rules introduced on 20 September 2004.

The issues of risk pooling and risk management are at best secondary concerns and at worst barely justifiable. These matters have been especially well addressed by the Institute of Actuaries in Australia in their submission. Even the regulations themselves call the significance of these issues into question. In relation to this latter point, we draw your attention to our previous submission, the relevant extract from which is repeated below:

> The new regulations require defined benefit funds and funds paying defined benefit pensions to have at least 50 members. In the case of the former class of funds, the requirement is for there to be at least that number of defined benefit members. ***However, the latter merely requires 50 members (not necessarily 50 defined benefit pension members).***
>
> In either case, we do not consider that the number of members is particularly relevant or helpful to the ability of a fund to satisfactorily manage its financial position or provide benefits to members.
>
> Specifically, the financial stability of a traditional employer-sponsored defined benefit fund is underpinned by the performance of its investments and the financial strength of the employer-sponsor—the number of members has no obvious significance.
>
> ***For funds paying defined benefit pensions, the regulations do not improve the integrity of the system at all well. We fail to see how, for example, a fund with 49 accumulation benefit members and one defined benefit pension member can be in a better position to manage its risks and financial position than a fund with only a single member in receipt of a defined benefit pension.***

(Emphasis added).

In the context of the current review, we do not support the need to consider the development of alternative products. Such an approach will simply introduce another unnecessary layer of complexity and additional costs and, therefore, we have not addressed these aspects of the Discussion Paper.

SISFA's Preferred Approach

As set out above, we stand unequivocally behind our preferred approach, articulated in our earlier submission, which we have no doubt will address any RBL compression/estate planning problems (actual or perceived) as well as restore equity and some faith in the small superannuation fund sector of the market.

Reasonable Benefit Limit (RBL) Concerns and Defined Benefit Pensions

We are now well aware that a major concern is the potential use of lifetime pensions to access large amounts of concessionally-taxed superannuation benefits and still be below the applicable RBL (so-called RBL "compression").

In this regard, however, we submit that the current measures do nothing to change the valuation of lifetime pensions for RBL purposes. On the contrary, they simply shut small funds out of that segment of the market. The RBL valuation of lifetime income streams from large superannuation funds remains the same in spite of these measures. Furthermore, RBL "compression" can continue to occur under the regulations where a lifetime pension from a small superannuation fund is provided by the purchase of a matching annuity from a life office.

The most effective way to address this matter is **not**, therefore, to simply ban small superannuation funds from providing such pensions. ***Rather, the method by which lifetime pensions are valued for RBL purposes must be reviewed and modified.*** One approach could be to replace the current formula-based RBL valuation with one based on the purchase price of the pension. The formula could remain appropriate for a lifetime pension that does not have a readily identifiable purchase price as may occur in a traditional corporate defined benefit fund or public sector scheme.

The existing provision in section 140ZO of the Income Tax Assessment Act 1936 ("Tax Act") requires the formula-based approach to be used for all lifetime pensions. To enhance the integrity of the RBL system this section could be amended as follows:

- Subsection (1) will only apply to lifetime pensions that are not "purchased";
- Subsection (2) is amended to allow the Commissioner to issue a determination for calculating the capital value of any pension with a purchase price.

The Commissioner can then issue a Taxation Determination for "purchased" lifetime pensions on a similar basis as Taxation Determination TD 2000/29, which deals with the capital value of other "purchased" pensions (such as allocated pensions). A formula-based valuation may still be appropriate to ensure there is no double-counting for RBL purposes in the long term. ***However, there must clearly be a revision of the arguably artificial impact that large undeducted contributions can have on the formula. In this regard, we fully support the amendment proposed by the Institute of Actuaries in Australia in their submission, which would clearly ensure that the inclusion of undeducted contributions would***

have no effect whatsoever on the RBL-assessable amount of a lifetime pension.

A review and modification of the standards prescribed in the SIS Regulations for the calculation of initial payments of lifetime pensions is also necessary to protect the integrity of the RBL valuation formula (see also the section following).

Taking these actions would most certainly address the so-called RBL compression aspects.

An alternative approach could involve a revision of the pension valuation factors that are required to be used for the valuation of lifetime pensions under the Tax Act. This is not without its problems, however, as it could have significant flow-on effects or retrospective application, particularly for corporate defined benefit funds or public sector schemes and even pensions that have commenced to be paid from any source. On balance, therefore, we would rule out a revision of the factors in Schedule 1B of the SIS Regulations and prefer a modification to the formula in section 140ZO as set out above. [We note, however, that if a 100% purchase price approach were adopted for lifetime pensions from small funds, then for reasons of equity an update to the factors would be required to ensure that the potential for such pensions paid from larger funds to be undervalued was removed.]

At this point, we should also emphasise that ***no explanation thus far has been offered for why life expectancy or fixed term pensions (categorised by definition as defined benefit pensions) have also been banned from small superannuation funds on a prospective basis. These types of pensions are essentially account-based, albeit the annual pension amount is fixed at their outset. We fail to see any reason against continuing to allow these pensions to be paid from small superannuation funds and note that they do not achieve "RBL compression" outcomes.***

Estate Planning Issues – Excess Reserves

The current requirements under the SIS Regulations arguably permit the commencement of a lifetime pension at an inappropriately low level relative to the capital supporting it. This has the potential for an "artificially" low RBL value and/or unreasonably high benefit reserve to be achieved. This is attributable in part to the requirement for an actuary to express an opinion that a fund has a "high degree of probability" (i.e. 70% probability) of being able to pay the defined benefit pension. The requirement is a minimum one, meaning that a higher degree of probability could possibly be applied, with a lower level of pension as a consequence.

Flexibility in the selection of reversionary beneficiary options (e.g. infants) may also exacerbate this situation.

The potential for any artificial or non-arm's length manipulation of these aspects could be addressed by amending the SIS Regulations to require defined benefit pensions to be commenced on a return of purchase price basis (i.e. consistent with the requirements under the Social Security Act).

We believe that such an approach would ensure that a reasonable and genuine level of retirement income relative to the amount of underlying capital was required to be paid. Furthermore, this would avoid the potential for excessive benefit reserves to arise. [Whether such reserve accumulations are necessarily problematic is discussed further in the next section.]

It should be noted that such modifications may in fact negate the need to change the current RBL valuation method applying to lifetime pensions (due to the various factors in the formula in section 140ZO of the Tax Act), with the probable exception of the impact of undeducted contributions on "purchased" lifetime pensions.

Other Estate Planning Concerns

We submit that our proposed alternative solutions set out above also address any concerns that defined benefit pensions are being used for estate planning rather than retirement income purposes. Of course, it must also be remembered at this point that a degree of estate planning is in fact contemplated by section 62 of the SIS Act (under the "sole purpose test").

We also believe that there were sufficient and effective safeguards already in place to deal with such concerns. Specifically, the following points are relevant:

- Any residual assets on the death of a pension member (or reversionary beneficiary) are retained in the fund to be applied for the benefit of any remaining members;
- Such amounts may become the superannuation benefits of other members, and are therefore subject to the preservation and payment rules under the SIS Regulations as well as ultimate RBL assessment (i.e. RBLs could potentially apply to the same benefit twice);
- Amounts allocated to remaining members are potentially subject to the superannuation contributions surcharge;
- If there are no remaining members and the remaining capital is paid to the deceased's estate, ETP tax will apply and a new RBL assessment (with possible excess benefits tax) will arise.
- Any reserve in the fund above the level determined by an actuary for income tax purposes (under section 283 of the Income Tax Assessment Act 1936) would not be eligible for exemption from tax, which would otherwise be the case with an allocated pension.

In relation the last two points raised above, we are particularly dismayed by the decision to include in the Discussion Paper the cameo analysis prepared by/for The Treasury for the purpose of highlighting the major areas of concern. While their inclusion could be useful to illustrate certain points, these cameos do not paint a full picture, include statements that are factually incorrect, and omit vital information (particularly in relation to income tax/RBLs) that would, if included, make a far less compelling argument in support of the measures. For these reasons, the inclusion of the cameos in their present form is grossly misleading in our view. For example:

- The income tax applicable to the reserves in a fund paying a lifetime pension could be substantial over the long term, and would thus reduce the level of assets remaining at any point in time;
- The residual assets in a fund paying a lifetime pension simply ***cannot*** be paid tax-free to a dependant on death in the vast majority of cases. In fact, most, if not all, of the capital remaining in "Cameo 2" would be fully taxable to a

dependent beneficiary as an ETP and also subject to a new RBL assessment (with obvious excess benefits tax consequences).

Actions and Summary

In conclusion, we re-submit that the only viable and acceptable options in relation to the provision of defined benefit pensions by small superannuation funds can be summarised as follows:

1. Repeal Divisions 9.2A and 9.2B of the Superannuation Industry (Supervision) Regulations 1994;

2. Review and amend section 140ZO of the Income Tax Assessment Act 1936 in relation to the RBL valuation of lifetime pensions and consider introducing an alternative for purchased pensions; and/or

3. Review and modify the basis for the calculation of the initial level of defined benefit pensions (i.e. on a return of purchase price basis).

We believe that these actions will not only remove the uncertainty regarding the changes, but will be a **more effective policy for improving the integrity of the superannuation system and remove any potential for the identified abuses of taxation laws** which may exist through small funds.

Further, all of the above actions can be put in place very quickly, with only minor and non-controversial legislative changes—however, the need for further and urgent consultation with interested parties is obvious, particularly with the end of the transitional period (on 30 June 2005) so imminent.

We look forward to participating further in The Treasury's review.

Yours sincerely

Michael Lorimer
Director and Chair

Graeme McDougall
Chief Executive Officer