challenger

Sydney

Level 2, 5 Martin Place
Sydney NSW 2000 Australia
GPO Box 3698
Sydney NSW 2001
www.challenger.com.au

Telephone 02 9994 7000
Facsimile 02 9994 7777

12 April 2017

Ms Laura Jones
Manager
Retirement Income Policy Division
Fiscal Group
The Treasury
PARKES ACT 2600

Dear Ms Johnson

Re: Consultation on the Treasury Laws Amendment (Innovative Superannuation Income Streams) Regulations 2017

Challenger Limited is Australia's largest provider of annuities and seventh largest fund manager with a vision to provide Australians with financial security for retirement. Challenger welcomes this opportunity to contribute to the development of regulations to define the new category of longevity products following the passage of the Treasury Laws Amendment (Fair and Sustainable Superannuation) Act No. 81, 2016.

This submission is supported by attached advice from KPMG on tax matters (Attachment A) and King & Wood Mallesons (KWM) on SIS matters (Attachment B).

Relevant Life Tables

Determining the rules for innovative longevity income streams presents an opportunity to make more contemporary the definition of life expectancy for tax purposes. With the ongoing Department of Social Services Review of Means Test Treatment of Retirement Income Streams there is also the opportunity to simultaneously make identical changes for social security purposes.

There is currently broad industry support for adopting the Australian Government Actuary's (AGA) age cohort life expectancies with 25-year improvements provided, for reasons of simplicity, they are used for both tax and social security purposes.

The primary objective of this proposal is to provide more realistic guidance to retirees, advisers and superannuation funds on longevity. The life tables currently used for this purpose reflect the current longevity experience of the population. Through time these have persistently understated the life expectancy of the retiree population. For this reason, while the AGA age cohort life expectancies with 25-year improvements rely on assumptions, they better reflect retirees' longevity.

The effect of this change of life expectancy tables in extending the period for which a death benefit is payable is not material in terms of:

- extending the period of LE/2 for a 100% death benefit and the capital access schedule;
- annuity pricing; or
- income efficiency.

A proportion of lifetime annuities are bought with ordinary money. The change of life tables would have a small tax impact on future annuitants in this category. Similarly it will have a small impact on Age Pension recipients by increasing reduced purchase prices and decreasing deduction amounts. With CIPRs expected to significantly increase the take-up of pooled longevity products it would be better to make this sensible recalibration now rather than face the prospect of a future change being seen, however modestly, to affect a much larger number of retirees.

Accruals taxation should not apply to deferred income streams prior to benefit payments

Challenger has for some years been making submissions that one of the impediments to the provision of deferred lifetime annuities is that they would be subject to accruals tax during the deferral period if bought by a superannuation fund. Our latest advice is that this continues to be the case under the TOFA provisions in Division 230.

A deferred annuity and supporting assets will be held in the complying superannuation class of a life insurance company prior to a condition of release being satisfied. Income from those assets will be subject to tax at 15%. If the superannuation fund is also subject to accruals tax on the annuity under TOFA, this will result in double taxation in respect of the individual's superannuation interest.

The issue does not arise once a condition of release is satisfied, as the deferred annuity would qualify for an earnings tax exemption.

The attached advice from KPMG proposes three possible solutions. Of these Challenger prefers the third, which proposes inserting into the ITAA97 a deeming provision to treat a deferred superannuation income stream that is a superannuation annuity held by a complying superannuation fund as if it has been issued for the benefit of a natural person.

The reason for this preference is that treating the deferred annuity as a separate interest relating to individual fund members would be consistent with another proposal in this submission, namely to look through a deferred annuity held by a superannuation fund and exclude it when calculating the minimum payments required from assets supporting an account based pension. This will provide neutrality between deferred annuities held directly by individuals and through a superannuation fund. It should also avoid introducing an extra layer of complexity when considering portability of deferred annuities under the proposed CIPR regime.

Valuation of deferred superannuation income streams

(a) **<u>The proposed valuation should take into account earnings tax prior to a condition of release</u>**

The proposed new regulation 307-205.02C seeks to value a superannuation interest that supports a deferred superannuation income stream by reference to the "above threshold rate" under the Social Security Act 1991. For a deferred annuity issued by a life insurance company, income from supporting assets will be subject to tax at 15% whilst held within the complying superannuation class.

We propose a simple amendment to apply only 85% of the above threshold rate to these calculations to recognise the economic effect of the earnings tax.

(b) **<u>The above threshold rate is not appropriate for a fixed rate deferred annuity</u>**

The use of a variable notional earnings rate that is likely to fluctuate, to value a fixed rate deferred annuity, is not appropriate because the annuitant will receive a fixed rate of return, irrespective of the returns on other types of assets against which the above threshold rate is set.

What is required is a separate provision for a deferred superannuation income stream that will pay a fixed rate of return, to fix the notional earnings rate in sub regulation 307-205.02C(2) at the above threshold rate on the day of issue of the deferred annuity by the life insurance company.

Unreasonable deferral of benefit payments – paragraph 1.06A(3)(c) SISR

The proposed new Regulation 1.06A contains a governing condition that the amount of benefit payments is determined using a method that ensures those payments are not unreasonably deferred after they start, having regard to the four factors listed in paragraph 1.06A(3)(c). Challenger supports the intent of this

integrity measure but notes there is no definition of “unreasonably deferred” in SISA, SISR, ITAA36, ITAA97, nor the regulations for either of the income tax Acts, and only limited guidance on how this principle will be applied to an innovative income stream.

To give confidence to both product issuers and customers it would be valuable to give some practical examples of benefit payment schedules which result in varying payments but which should not give rise to concerns that those benefits are being unreasonably deferred. Two such examples are contained in the KPMG advice attached to this submission.

A public ruling in the form of an ATO Law Companion Guide setting out a range of benefit payment scenarios that are not unreasonably deferred would allow products with the same features to be brought to market quickly without the need for a specific product ruling. Product issuers could then make their own judgements about whether proposed products not covered by the Law Companion Guide are sufficiently uncertain to require a specific product ruling.

As the provision is contained in the SIS regulations the attached advice from KWM considers the role that APRA might have in determining whether income is being unreasonably deferred and proposes an addition to paragraph 1.06A(3)(c) which would provide for APRA to make a determination in relation to an income stream or method of determining benefit payments.

Mutually exclusive products

The draft regulations have been drawn to create under sub regulation 1.06A(1) a new class of products which meet the capital access schedule but have more flexibility in relation to the deferral and variability of payments than the closely specified products defined in sub regulation 1.05(11A). They must respectively meet the provisions of sub regulations 1.05(11A) and 1.06(9A). However one of the requirements for the new category of products is that they do not meet the requirements of the existing category of products, which means the product types must be mutually exclusive.

We understand that the purpose of this rule is to ensure that this category is confined to pooled longevity products, permitting both deferral and more variability in payments than existing product types. However we do not see that there is a logical policy reason to include a blanket requirement that for an annuity to qualify under sub regulation 1.06A(1) it must not qualify under sub regulation 1.05(11A).

Depending on market conditions some annuities will at times not fit sub regulation 1.05(1) and therefore qualify under sub regulation 1.06A(1) but at other times fit sub regulation 1.05(11A). This creates unnecessary complexity both for product providers and taxation authorities.

The most relevant and current example is immediate lifetime annuities that are CPI indexed. These are explicitly intended to be a permitted product type under sub regulation 1.05(11A). However, in the current low interest rate environment a properly priced CPI indexed immediate lifetime annuity will fail to meet the minimum drawdown requirements in the first year for those at normal retirement ages. The problem is worse for women who, because of their expected longevity, receive a lower rate. In this case younger annuitants purchasing a CPI indexed lifetime annuity would qualify under sub regulation 1.06A(1) but older annuitants buying an identical product with a higher rate would qualify under sub regulation 1.05(11A) and therefore be excluded under sub regulation 1.06A(1). The situation could then be reversed for frail aged annuitants with much higher drawdown requirements who might only qualify under sub regulation 1.06A(1). The ages at which these crossovers between product types occur could change whenever a shift in the yield curve requires that pricing be adjusted.

This would require consideration of the treatment of each individual retiree to determine into which product type their annuity would fall, rather than considering the issue on the basis of a specific product.

This is a current issue which life offices deal with by making adjustments to payment rates and indexation arrangements so that more retirees can obtain what would otherwise be a simple CPI indexed immediate lifetime annuity. As CPI indexed immediate lifetime annuities are a basic building block for CIPRs this needs to be fixed.

We propose a potential solution which is contained in the attached advice from KWM.

Look through on hybrid products

The draft regulations provide different treatment for simple hybrid products (a DLA or immediate lifetime annuity and an account based pension (ABP) inside a superannuation fund) compared to an individual who buys an ABP and an annuity separately and directly.

The inequality affects minimum drawdown requirements. The attached advice from KWM shows how an ABP and DLA in a superannuation fund will initially have higher drawdown requirements than if the two products were bought separately. When the DLA reaches the trigger date for payment, the necessary draw on the ABP to meet the minimum drawdown requirements would then be reduced compared to a situation where equivalent products were bought separately.

For retirees with low starting balances the higher initial minimum drawdown requirements for the composite product may result in a need to shorten the deferral period for the DLA with a material impact on payment rates. For retirees with higher starting balances the resulting lower minimum drawdown requirements from the account based component when the DLA commences payment may have estate planning benefits.

We believe it would be good policy to provide neutrality between deferred annuities held directly by individuals and through a superannuation fund. The attached KWM advice provides an amendment to provide for look through treatment of hybrid products.

We have made a submission to the Department of Social Services consultation on the Means Test Treatment of Retirement Income Products which proposes look through treatment for social security treatment of hybrid products. Apart from providing neutrality of treatment, look through arrangements will simplify the portability of individual components of CIPRs.

Life expectancy concepts – "remaining life expectancy" minus one

The formula for "remaining life expectancy", after taking into account the "life expectancy period," age at commutation and primary beneficiary's age takes the resulting "retirement phase start date" and subtracts one. This is an integrity measure designed to remove the opportunity for retirees to rollover a product at a strategic date into the same or a similar product to maintain access to 100% of their capital.

The minus one formula has three drawbacks:

1. it would be complicated to explain to retirees and intuitively unappealing;
2. it results in the removal of a year of the capital access schedule after only 14 days and without any payment to the retiree actually having been made; and
3. it results in the removal of the last year of the capital access schedule on the first day of the last year.

An alternative integrity measure that achieves the same objective is reducing access to capital on a monthly schedule. Worked examples are provided at Attachment C. Thisapproach would:

1. coincide with industry practice of monthly payments and so reduce system costs;
2. provide a closer fit with the straight line concept of the capital access schedule;
3. be easier to explain to retirees; and
4. be fairer.

The attached advice from KWM contains some suggested refinements to the definitions.

Primary beneficiary concept in reversionary pension context

The draft regulations define the "life expectancy period" by reference to "the number of years in the complete expectation of the life of the primary beneficiary of the benefit".

A majority of people enter retirement as a couple. There are sound reasons for couples to buy annuities with a reversionary benefit to provide longevity protection for both partners. There may be differences in their ages and it is standard industry practice to price their combined longevity. No mischief can arise from this.

The precedents under existing legislation, which are set out in the attached advice from KWM, are that the Commissioner should consider life expectancy having regard to the number of years in the total period during which the annuity will be, or may reasonably be expected to be payable. Pages 97 and 98 of the EM

to the Income Tax Assessment Amendment Act (No.3) 1984, provide examples that include reversionary benefits.

The definition of life expectancy for reversionary benefits under these regulations should be redrafted to be consistent with this legislation.

Death of primary beneficiary during the deferral period

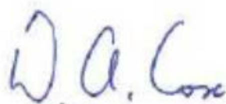
Regulation 1.06A(3)(a) requires that in the case of a DLA a reversionary benefit not be paid if the primary beneficiary has died during the deferral period. This provision and its policy rationale are not explained in the EM, possibly because it is inexplicable. It effectively precludes offering a DLA with a reversionary benefit.

There is a substantial superannuation asset gender gap and for practical purposes many women, and some men too, must rely either on reversionary benefits or bequests from spouses for retirement income. This regulation will deny them access to the most efficient form of longevity protection. It is incompatible with the concept of joint CIPRs or more generally with reducing the superannuation asset gender gap by considering retirement incomes on a household basis as the Age Pension does.

You may also wish to consider this regulation in the light of Section 62 of the Superannuation Industry (Supervision) Act 1993. The sole purpose test identifies amongst the core purposes that benefits are provided “to any or all of the member’s dependants.”

Challenger is generally pleased with the draft regulations but we believe we have identified a number of significant issues. We think we have provided some useful commercial insights. We believe that a number of the proposals we have made are important to better integrate the new category of lifetime products with the proposed CIPR regime and the necessary revisions to the means test treatment of retirement income streams.

Yours faithfully



David Cox
Head of Government Relations

Attachment A

KPMG Law

Level 38 Tower Three
300 Barangaroo Avenue
Sydney NSW 2000

P O Box H67 Australia Square
Sydney NSW 1213
Australia

ABN: 78 399 289 481

Telephone: +61 2 9335 7000
Facsimile: +61 2 9335 8968
DX: 1056 Sydney
www.kpmg.com.au

Mr David Cox
Head of Government Relations
Challenger Limited
Level 2
5 Martin Place
Sydney NSW 2000

Our ref 29206574_8.docx

Contact Peter Oliver (+61 2 9455 9520)
Craig Marston (+61 2 9346 5644

12 April 2017

Dear David,

Draft Innovative Superannuation Income Stream regulations - Income tax matters for submission

We refer to our recent discussions regarding the draft *Treasury Laws Amendment (Innovative Superannuation Income Streams) Regulations 2017* and draft Explanatory Statement that were released for public consultation on 21 March 2017. These proposed new regulations seek to introduce a flexible set of design rules to allow for new lifetime superannuation income stream products, including deferred income products, investment-linked pensions and annuities and group-self annuitised products.

We have been requested to advise Challenger Limited ("Challenger") on matters arising under the draft regulations which warrant a submission to Treasury insofar as they relate to the *Income Tax Assessment Act 1997* ("ITAA 97") and/or *Income Tax Assessment Act 1936* ("ITAA 36").

Legislative references below are to the ITAA 97 and ITAA 36 unless otherwise stated. Our comments also refer to the *Superannuation Industry (Supervision) Act 1993* ("SISA") and the *Superannuation Industry (Supervision) Regulations 1994* ("SISR") given their close interrelationship with the income tax legislation relevant to the proposed new income stream products.

Background

The proposed regulations are intended to outline the requirements for new income stream products that can qualify as exempt life insurance policies held in the segregated exempt assets (SEA) of a life insurance company after satisfaction of a relevant condition of release under SISR.

Broadly, the design framework to allow for these new products was included in Schedule 8 of *Treasury Laws Amendment (Fair and Sustainable Superannuation) Act 2016* ("the Amending Superannuation Act"), which allows an annuity to qualify for inclusion in the SEA of a life insurance company if it is not an immediate annuity but is a superannuation income stream that is in the "retirement phase" (amendments to paragraph 320-246(1)(a) and new paragraph 320-246(1)(ea)). A superannuation income stream will be in the "retirement phase" if it is a

KPMG Law is an Australian partnership and an associated entity of KPMG. KPMG is an Australian partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International") a Swiss entity.

Liability limited by a scheme approved under Professional Standards Legislation.

"deferred superannuation income stream", which is defined in the ITAA 97 by reference to its meaning under SISR (new Section 307-80 and definitions in Section 995-1).

The draft regulations include the following proposed new regulations:

- SISR regulation 1.06A outlines the governing conditions to qualify as an innovative income stream and be included within the definition of an annuity under existing regulation 1.05. Broadly, those conditions include:
  - Before payments commence, the primary beneficiary of the income stream must satisfy either of the conditions of release in item 101 (retirement), 102A (terminal medical condition), 103 (permanent incapacity) or 106 (age 65) of Schedule 1 SISR.
  - The income stream continues for the lifetime of the beneficiary once it commences.
  - Benefit payments must not be "unreasonably deferred" once they commence, having regard to certain factors.
  - If commuted on or after the "retirement phase start day", the commutation amount must not exceed an Access amount amortised over the life expectancy of the primary beneficiary (under new regulation 1.06B).
  - Limitations on commutation before the "retirement phase start day" (in accordance with conditions of release under regulations 6.16, 6.18, 6.19 and 6.22A SISR), limitations on transfer of the benefit (only on death of the beneficiary) and a restriction on the value of the benefit being used as security for a borrowing.
- New income tax regulations:
  - To treat amounts supporting deferred superannuation income streams under the new SISR regulation 1.06A as separate superannuation interests (new regulation 307-200.05).
  - To value the superannuation interest supporting a deferred superannuation income stream (new regulation 307-205.02C), which imposes a deemed earnings rate on the purchase consideration using the "above threshold rate" under the *Social Security Act 1991*. This is to be used for calculating the credit to an individual's transfer balance account under the new Section 294-25.
  - To value the superannuation interest supporting a collective defined contribution scheme (new regulation 307-205.02D).

Matters for submission

1 – Accruals taxation should not apply to deferred income streams prior to benefit payments

The proposed new regulations and definition of when a superannuation income stream is in the "retirement phase" (Section 307-80) will result in a deferred income stream qualifying for an income tax exemption once one of the conditions of release outlined earlier has been satisfied. Prior to this time, a deferred annuity will be included in the issuing life insurance company's

complying superannuation class and income arising from supporting assets in this class will be subject to income tax at 15%.

For the reasons outlined below, it appears that deferred annuities issued by a life insurance company to a superannuation fund will be subject to accruals taxation under the TOFA provisions in Division 230. This does not give rise to an issue once a condition of release is satisfied, as the deferred annuity would qualify for an earnings tax exemption. However, accruals taxation under TOFA would arise prior to a condition of release being satisfied, giving rise to double taxation as outlined below.

As noted above, a deferred annuity and supporting assets will be held in the complying superannuation class of a life insurance company prior to a condition of release being satisfied. Income arising from those assets will be subject to tax at 15%. If the superannuation fund is also subject to accruals taxation on the annuity under TOFA, this will result in double taxation in respect of the individual's superannuation interest. This is illustrated by the following simple example.

Assume:

- A deferred annuity is issued under the new Regulation 1.06A to a superannuation fund in respect of a member that is aged 55. The purchase premium is $100.
- The deferred annuity will commence payments after 20 years, at age 75 and the individual dies at age 85.
- The life company earns $10 income per year from assets invested in support of the annuity (the example simplistically assumes a fixed amount of income is earned each year). The life company receives $50 of implicit fee income.
- Accordingly, the cash flow position of the life insurance company is summarised as follows (for simplicity, the example doesn't subtract the $50 fee income until the end):
  - On initial sale: $100 assets (premium received)
  - After 10 years: $185 assets ($100 income derived whilst held in the complying superannuation class, less $15 tax at 15%). The annuity moves into the SEA after 10 years when the individual turns 65.
  - After 20 years: $285 ($100 income derived whilst held in the SEA).
  - After 30 years: $385 (further $100 income whilst held in the SEA)
less ($335) (annuity payments over years 21-30)
$50 (life company profit)
- If the superannuation fund is also subject to TOFA accruals taxation on the annuity during years 1-10, further tax would arise. For simplicity, rather than doing a detailed compounding accrual calculation, assume that the TOFA assessable amount was 1/3 of the total annuity gain, representing the proportion of years 1-10 to the total life of the annuity. This would be assessable income of $78, representing 1/3 x [$335 *less* $100 premium]. This would give rise to tax of $11.75 in the superannuation fund.

- Total tax borne during years 1-10 would be $26.75 across the life company and superannuation fund, resulting in an effective tax rate of 26.75% on $100 income during the time when the annuity is held in the accumulation phase.

By way of contrast, an immediate annuity is not subject to double taxation as:

- no taxation arises on income from supporting assets within the issuing life insurance company as it will be an exempt life insurance policy under Section 320-246; and
- either:
  - the immediate annuity is a segregated pension asset and income from the annuity is exempt under Section 295-385 (this example assumes a segregated complying superannuation fund); or
  - the immediate annuity is not a segregated pension asset and income from the annuity will be subject to tax at 15% (the TOFA provisions in Division 230 would apply to the annuity).
- Accordingly, only a single level of taxation would apply to an immediate annuity during the accumulation phase (taxed in the superannuation fund), whereas from 1 July 2017 a deferred annuity held by a superannuation fund before a condition of release is satisfied will give rise to taxation both on income from supporting assets in the life insurance company (complying superannuation class) and accruals taxation under TOFA in the superannuation fund.

The proposed regulations allow and encourage individuals to acquire deferred income streams before a condition of release is met (e.g. Example 1.2 of the draft Explanatory Statement includes an annuity purchased by "Suzie" before her retirement). The taxation of deferred income streams prior to the commencement of payments would be a strong disincentive to the acquisition of these products by individuals through a superannuation fund, resulting in an effective tax rate substantially above 15% on accumulation phase income and acting against the policy intent of these measures to encourage individuals to protect against longevity risk by acquiring deferred income streams.

Proposed solution

Divisions 16E and 230 apply to tax qualifying securities on an accruals basis. "Qualifying security" is defined in subsection 159GP(1), which provides that the term qualifying security does not include an annuity, except where provided by subsection 159GP(10).

As currently drafted, subsection 159GP(10) states that an annuity can be a qualifying security if the annuity is not an "ineligible annuity". An "ineligible annuity" is:

> ***"ineligible annuity*** means an annuity issued by a life assurance company to or for the benefit of a natural person other than in the capacity of trustee of a trust estate."

As the definition of ineligible annuity applies to those held by a natural person (other than in a capacity of trustee), the concern with double taxation does not arise where an individual directly acquires a deferred annuity that is a deferred superannuation income stream.

We understand that the ATO's Tax Counsel Network is currently considering whether an annuity, including a deferred annuity, held by a superannuation fund can be an ineligible annuity on the basis that a superannuation fund acquires it for the benefit of a natural person (one or more fund members). We would welcome this interpretation if confirmed by the ATO in a public ruling which can be relied upon by taxpayers. However, uncertainty arises because the ATO has previously ruled in a number of different contexts that amounts received via a trust do not have the same character when passed through a trust, for example in *Taxation Determination TD 2008/25* the ATO states that for bare trust situations a dividend received by a trustee will not have the same character when received by a beneficiary:

> "*16. …..Furthermore, the Commissioner considers that what the corporate beneficiary receives does not have the character of a dividend. Rather, it is an amount of trust net income that is attributable to the dividend: Federal Commissioner of Taxation v. Angus (1961) 105 CLR 489.*"

Our concern is that the definition of an "ineligible annuity" is not sufficiently clear to conclude that an annuity acquired by the trustee of a superannuation fund will be issued for the benefit of a natural person, particularly where the member(s) of the superannuation fund will benefit from a net amount (income arising on fund assets less expenses and trustee fees of the superannuation fund). Further, it is also unclear whether an annuity acquired on behalf of a group of superannuation fund members could be an ineligible annuity given that the definition is stated in the singular to refer to "a natural person".

If the ATO is unable to conclude that an annuity held by a superannuation fund is an ineligible annuity, the potential for double taxation could be resolved in alternative ways, including:

1 treating a deferred superannuation income stream that is a superannuation annuity (issued under SISR Regulation 1.06A) as an exempt life insurance policy at all times where it is held by a complying superannuation fund; or

2 the definition of ineligible annuity in subsection 159GP(1) could be amended to explicitly include a deferred superannuation income stream that is a superannuation annuity during the payment deferral period; or

3 a deeming provision could be inserted into the ITAA 97 to treat a deferred superannuation income stream that is a superannuation annuity held by a complying superannuation fund as if it has been issued for the benefit of a natural person. This approach could involve the same proposed amendment for solution 2 above (see proposed legislative amendment below) or a different amendment to the ITAA 97 to treat the deferred annuity as a separate interest relating to individual fund members such that it is treated as an ineligible annuity.

The third approach is attractive as it is consistent with Challenger's proposal to achieve neutrality by looking through hybrid (composite) products and separately recognising a deferred annuity held by a superannuation fund (Challenger's submission incorporates a proposal from King & Wood Mallesons that separately recognises a deferred annuity for SISA and SIR minimum payment purposes when the deferred annuity is acquired using assets held in support of an account based pension).

We set out proposed amendments for items 1 and 2 below (as noted, item 3 could be drafted in a variety of ways).

1 - PROPOSED AMENDMENT: SUBSECTION 307-80(2)

To be amended to read as follows (changes underlined):

A *superannuation income stream is also in the ***retirement phase*** at a time if:

(a) it is a *deferred superannuation income stream; and

(b) a *superannuation income stream benefit will be payable from it to a person after that time; and

(c) <u>either:</u>

<u>(i) where the superannuation income stream is a *superannuation annuity issued to a natural person other than in the capacity of trustee of a trust estate,</u> the person has satisfied (whether at or before that time) a condition of release specified in any of the following items of the table in Schedule 1 to the *Superannuation Industry (Supervision) Regulations 1994*:

(<u>**A**</u>) 101 (retirement);

(<u>**B**</u>) 102A (terminal medical condition);

(<u>**C**</u>) 103 (permanent incapacity);

(<u>**D**</u>) 106 (attaining age 65)<u>; or</u>

<u>(ii) the annuity is held by the trustee of a fund that is a *complying superannuation fund or a *complying approved deposit fund, a *life insurance company and is a *complying superannuation asset of that company or a trustee of a *pooled superannuation trust.</u>

2 - PROPOSED AMENDMENT: SUBSECTION 159GP(1) ITAA 36

To be amended to read as follows (changes underlined):

ineligible annuity means an annuity issued by a life assurance company:

(a) <u>for all annuities – where the annuity is issued</u> to or for the benefit of a natural person other than in the capacity of trustee of a trust estate; or

(b) where the annuity is a *deferred superannuation income stream that is not in the retirement phase.

Any legislative amendment needs to be effective from 1 July 2017 to align with the commencement date of the proposed new regulations.

2 – Valuation of deferred superannuation income streams

a) The proposed valuation of deferred superannuation income streams should take into account income tax on earnings prior to a condition of release being satisfied

Proposed new regulation 307-205.02C seeks to value a superannuation interest that supports a deferred superannuation income stream by reference to the “above threshold rate” under the *Social Security Act 1991*.

The formula in subregulation 307-205.02C(2) does not include any allowance for income tax that may be borne in relation to the deferred superannuation income stream prior to a condition of release being satisfied. For a deferred annuity issued by a life insurance company, income from supporting assets will be subject to tax at 15% whilst held within the complying superannuation class.

Accordingly, the assumed earnings rate in subregulation 307-205.02C(2) should be adjusted to allow for income tax at 15%.

PROPOSED AMENDMENT: subregulation 307-205.02C(2)
To be amended as follows (changes underlined):

(2) An amount of consideration paid for the interest for the income stream, and that amount's associated notional earnings, for a particular day (the ***valuing day***) is worked out by applying the following formula for each adjustment day (from the earliest to the latest):

$$\text{Compounded amount of consideration just before the adjustment day} \times \left(1 + \text{Applicable above threshold rate for the adjustment day}\right)$$

where:

above threshold rate, for a particular day, means 85% of the rate determined for that day under subsection 1082(2) of the *Social Security Act 1991*.

b) The above threshold rate is not appropriate for a fixed rate deferred annuity

The formula for valuing a deferred superannuation income stream under subregulation 307-205.02C(2) assumes that the notional earnings on the consideration paid for the interest will vary over time because it is based on the above threshold rate under subsection 1082(2) of the *Social Security Act 1991*. This rate varies over time when it is reset by legislative instrument and is used as a benchmark for measuring returns from all financial assets of an individual or couple for social security purposes.

The use of a variable notional earnings rate to value a fixed rate deferred annuity is not appropriate because the annuitant will achieve a fixed rate of return, irrespective of returns available on other types of assets. Accordingly, for a deferred superannuation income stream that will pay a fixed rate of return, the notional earnings rate in subregulation 307-205.02C(2) should be fixed at the above threshold rate on the day of issue of the deferred annuity by the life insurance company.

3 – Unreasonable deferral of benefit payments – subregulation 1.06A(3)(c) SISR

The proposed new Regulation 1.06A contains a governing condition that the amount of benefit payments are determined using a method that ensures that those payments are not unreasonably deferred after they start, having regard to the four factors listed in subregulation 1.06A(3)(c).

There is limited guidance on how this principle will be applied to an innovative new income stream as:

- The term "unreasonably deferred" is not defined in SISA, SISR, ITAA 36, ITAA 97 nor the regulations for either of the income tax Acts.
- The draft Explanatory Statement includes only a brief example of an unreasonable deferral for a deferred annuity (annual payments of $1,000 for 20 years, followed by $50,000 p.a. for subsequent years).
- Although a similar restriction on the "unreasonable deferral" of payments under an immediate annuity is included in Item 4 of the table in subsection 320-246(3), there is no substantive guidance on what that term means as subsection 320-246(3) only lists similar factors to those in the proposed subregulation 1.06A(3)(c), being when payments are made and returns on supporting assets are derived; the relative sizes of annual payments from year to year where not dependent on returns from supporting assets; and any other relevant factors.
- There is no ATO or other substantive guidance on the meaning of an "unreasonable deferral" of a payment in this context nor for subsection 320-246(3). The only ATO ruling on the meaning of "unreasonable deferral" was withdrawn on 5 April 2017 (IT 2492), although that dealt with former legislative provisions and was withdrawn as it had no ongoing relevance.

To encourage the development of innovative products that offer retirees flexibility in planning for their superannuation income streams, it is important that practical examples are available, which demonstrate a variety of circumstances where benefit payments will not be unreasonably deferred. This will give both product issuers and customers confidence in the SISR and income tax treatment applicable to new innovative income stream products. It will also allow products that align with the examples provided to be brought to market without delay that may be required if regulator clearance is needed in order to obtain certainty that the unreasonable deferral condition is satisfied.

Given that the unreasonable deferral requirement is within the proposed SISR regulation, it is not clear from the draft regulations nor Explanatory Statement which regulator will be

responsible for determining whether this requirement is satisfied for new products. Whichever regulator has this responsibility, it is critical that practical guidance and examples are issued, which can be relied on by product issuers, to allow the timely launch of new products with certainty as to what types of features will be acceptable.

If the ATO is responsible for determining whether a new product satisfies the unreasonable deferral condition, we suggest that an optimal approach will involve a combination of:

- a public ruling from the ATO outlining the range of benefit payment scenarios that will not be unreasonably deferred and including various example income stream products. This could be in the form of a Law Companion Guide and would allow products with the same features to be launched to market quickly without needing to seek a specific product ruling; and
- product issuers can determine whether different features to those outlined in the Law Companion Guide are sufficiently uncertain to require a specific product ruling from the ATO. Although a product ruling would involve a slower timeframe in bringing a product to market, this would allow for certainty on the income tax consequences of more complex products.

We set out below some suggested examples that would merit inclusion in a new Law Companion Guide.

<u>Example 1 – non-deferred variable annuity</u>

An annuity could make a fixed annual payment for life together with a variable annual payment that is referable to an externally recognised index/benchmark.

For example, a lifetime annuity could pay a fixed $3,000 per annum income payment for life together with a variable annual payment (positive or negative) referable to the RBA cash rate.

Assuming:

- Assume purchase price is $100,000
- RBA cash rate in year one is 1.50%
- RBA cash rate in year two is -0.25%
- RBA cash rate in year three is 1.00%
- RBA cash rate in year four is 2.00%
- RBA cash rate in year five is 3.00%
- RBA cash rate in year six is 2.00%

	Year 1 payment	**Year 2 payment**	**Year 3 payment**	**Year 4 payment**	**Year 5 payment**	**Year 6 payment**	**Payments ongoing for life**
Fixed component	$3,000	$3,000	$3,000	$3,000	$3,000	$3,000	$3,000
Benchmark component[1]	$1,500	-$250	$1,000	$2,000	$3,000	$2,000	As calculated
Total payment[2]	**$4,500**	**$2,750**	**$4,000**	**$5,000**	**$6,000**	**$5,000**	As calculated

[1] The 'benchmark component' would equal purchase price multiplied by RBA cash rate, adjusted for changes in the RBA cash rate from time to time.
[2] A 'benchmark component' payment floor would ensure an annual payment would be made each year.

In this example the issuing life insurance company may or may not hold assets earning returns equal to the fixed return of 3% and the RBA cash rate benchmark. In either circumstance, there would be no unreasonable deferral of income whether paragraph 1.06A(3)(c)(i), (iii) or (iv) is applicable to the annuity.

Example 2
An annuity could make guaranteed payments that are indexed annually (or more frequently) by an externally recognised benchmark.

For example, along with the changes to the CPI, income payments could also be indexed annually by such benchmarks as:
- RBA Cash Rate,
- S&P/ASX 200,
- MSCI Net World,
- Bloomberg AusBond Treasury Index
- Bloomberg AusBond Composite Index

Income payments would reduce where the change in the relevant benchmark/index was negative.

Similar to Example 1, the issuing life insurance company may or may not hold assets earning returns equal to the benchmark. In either circumstance, there would be no unreasonable deferral of income whether paragraph 1.06A(3)(c)(i), (iii) or (iv) is applicable to the annuity.

Other examples

To issue a comprehensive Law Companion Guideline, the ATO will need examples of products under consideration by other stakeholders, e.g. group self-annuitisation products that may be considered by superannuation funds. The ATO could seek examples through consultation with relevant industry groups, similar to the ongoing consultation it has undertaken for other Law Companion Guidelines in relation to the superannuation reforms.

* * * * *

Our income tax advice is based on current taxation law as at the date our advice is provided. You will appreciate that the tax law is frequently being changed, both prospectively and retrospectively. A number of key tax reform measures have been implemented, a number of other key reforms have been deferred and the status of some key reforms remains unclear at this stage.

Unless special arrangements are made, this advice will not be updated to take account of subsequent changes to the tax legislation, case law, rulings and determinations issued by the Australian Commissioner of Taxation or other practices of taxation authorities (including the relevant State or Territory Revenue Offices). It is your responsibility to take further advice, if you are to rely on our advice at a later date.

Neither the firm nor any member or employee of the firm undertakes responsibility in any way whatsoever to any person or company other than Challenger for any errors or omissions in the advice given, however caused.

Yours sincerely

Peter Oliver
Partner

ATTACHMENT B

KING & WOOD MALLESONS

Level 61
Governor Phillip Tower
1 Farrer Place
Sydney NSW 2000
Australia

T +61 2 9296 2000
F +61 2 9296 3999

www.kwm.com

12 April 2017

To David Cox
Head of Government Relations
Challenger Limited
Level 2
5 Martin Place
SYDNEY NSW 2000

Dear David

Treasury Laws Amendment (Innovative Superannuation Income Streams) Regulations 2017

1 Introduction

1.1 This letter is provided in support of the submission we understand Challenger intends to make to Treasury in response to the draft *Treasury Laws Amendment (Innovative Superannuation Income Streams) Regulations 2017*, released for consultation on 21 March 2017 ("**Draft Regulations**"). Our comments on the issues Challenger proposes to raise in relation to the Draft Regulations are set out in the following paragraphs.

2 Mutually exclusive products

Issue

2.1 Currently, retirement income stream products are regulated by SIS,[1] and the SIS Regulations.[2] Relevantly:

(a) SIS Regulation 1.05(1) provides that a benefit given by a life insurance company or a registered organisation is taken to be an annuity for the purposes of SIS if it arises under a contract meeting the criteria in subregulation 1.05(11A); and

(b) SIS Regulation 1.06(1) provides that a benefit is taken to be a pension if it is provided under the rules of a superannuation fund that meet the standards of subregulation 1.06(9A).

2.2 Applying the provisions of SIS Regulations 1.05(11A) and 1.06(9A) is not straightforward. The SIS Regulations identify numerous types of pension and annuity, however these variations (each, a "**Type**") are effectively considered in "silos". For a pension or annuity to comply with the SIS Regulations, it must conform to a particular Type.

---

[1] *Superannuation Industry (Supervision) Act 1993* (Cth) ("**SIS**").

[2] *Superannuation Industry (Supervision) Regulations 1994* (Cth) ("**SIS Regulations**").

2.3 The introduction in the Draft Regulations of subregulation 1.06A creates a new Type ("**New Type**"). However, a pre-condition to a product falling within the ambit of 1.06A is that it must not meet the standards in subregulations 1.05(11A) or 1.06(9A).[3] This creates a situation where a product may be developed with the intent that it will be a New Type pension or annuity but fail to do so because it inadvertently satisfies one of those standards.

2.4 We understand that one reason why Treasury included this requirement was to ensure that an account-based pension would not qualify as a New Type. We don't share Treasury's concern, because an account-based pension would fail to satisfy the New Type conditions, in particular because an account-based pension would not be payable "throughout the life" of the beneficiary (Draft Regulations, 1.06A(3)(b)).

2.5 We further understand that Treasury was concerned that there be no ambiguity about a product's Type.

2.6 We do not see that there is a logical policy reason to include a blanket requirement that, for a pension or annuity to qualify as a New Type, it must be one which fails to meet a standard for any of the existing Types. If a pension or annuity satisfies all of the criteria for the New Type, this should be sufficient for classification purposes, without a provider having to satisfy itself that the product does not accidentally comply with the criteria for a different Type.

2.7 Imposing a requirement to check each New Type product not only for compliance with the New Type requirements but also for non-compliance with each other Type's requirements appears onerous and likely to add significantly to compliance costs associated with these products.

2.8 To the extent that the provision was intended to exclude any particular characteristic associated with an existing Type, we would suggest that any such requirement be explicitly introduced into the Draft Regulations as part of the criteria of the New Type. This would allow for a simpler checklist of requirements for providers, while still shaping the New Type in the desired way.

2.9 To illustrate the issue, we understand that in the current low rate environment, it is highly unlikely in some cases for a standard immediate lifetime annuity product to be priced so that it meets the existing minimum payment amount requirements in SIS Regulation 1.05(11A)(b)(i)(B) and (ii)(D). It may be possible for such a product to fit within the New Type classification. However, in the future, should interest rates rise, the product pricing will change to reflect this and at that time, the same product may comply with the minimum payment amount requirements simply as a result of repricing and with no change to the contract terms. The result will be that a product of this kind may have to comply with a different set of requirements at different times, simply because of market movements.

Solution

2.10 A potential solution would be to replace the requirement that, in order to qualify under subregulation 1.06A, a product must not qualify under any existing Type with a more limited requirement, namely that the product must not qualify as an account-based pension or annuity and also to ensure that the issuer of a product identifies when a product is intended to be a New Type product. This could be achieved by amending subregulation 1.06A(2) as follows:

> "*(2) The governing conditions meet the standards of this subregulation if:*
>
> *(a) they neither meet the standards in subregulation 1.05(11A)(a) nor the standards in subregulation 1.06(9A)(a) (as applicable); and*
>
> *(b) they comply with subregulation (3) of this regulation; and*

[3] Draft Regulations, 1.06A(2)(a).

(c) *either:*

(i) *they ensure that payment of the benefit is made at least annually; or*

(ii) *the benefit is a deferred superannuation income stream.; and*

(d) *they include a statement that the benefit is an innovative superannuation income stream which complies with this subregulation.*

2.11 This amendment would provide certainty and remove potential confusion associated with the inadvertent satisfaction of the conditions of a separate Type while addressing Treasury's concerns as we understand them. Importantly, so long as a new product fits the criteria for a New Type, a provider would not have to conduct a detailed (and costly) analysis to confirm that the product didn't inadvertently also fall within an existing Type. This would significantly reduce compliance costs for each new product (or variation to a product), and avoid a situation where a product has to be designed to *not* fit within an existing Type.

3 Look through on hybrid products

Issue – context

3.1 Each of SIS Regulation 1.05(11A) and 1.06(9A) creates 2 limbs: on the one hand, there is criteria applicable to account based products. On the other hand, there is criteria applicable to 3 Types of product where there is no account balance attributable to the annuitant/beneficiary (as noted above, the Draft Regulations also create the New Type).

Issue – "Composite" or "Hybrid" Products

3.2 The cumulative effect of this "silo" approach to Types is that a product must fall within the criteria set out for one Type only. An issue arises where an issuer provides a product that incorporates elements of more than one Type of product. Typically, this would take the form of an account based pension product where part of the account is invested in a deferred lifetime annuity ("**DLA**") and the remainder is invested in securities such as managed funds and other types of investment. The concept is to "wrap" up two discrete types of investment (with very different cash flow patterns) into a single product for the consumer. For present purposes, we will refer to this as a "**Composite Product**" (although we note that it is sometimes described as a "hybrid" product).

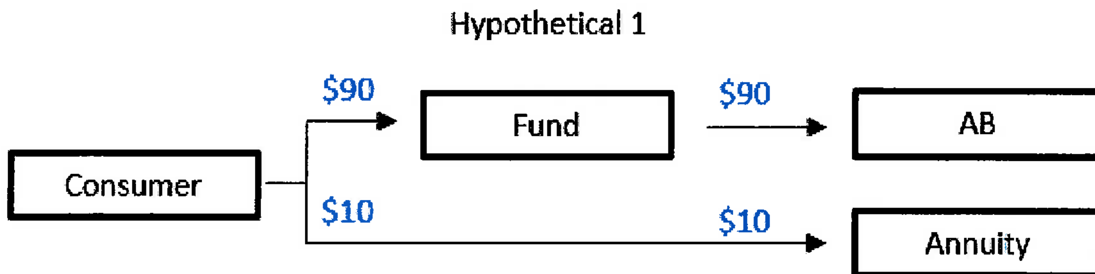
3.3 We expect that products of this kind (where more than one form of income stream are "bundled" together to form a single product, typically a superannuation pension which may in part be funded by the purchase of a DLA) will become prevalent as trustees seek to design products that will qualify as Comprehensive Income Products for Retirement (or "MyRetirement" products).

3.4 There is currently no mechanism in the SIS Regulations to look through and treat a Composite Product as if it consisted of multiple pensions/annuities despite being presented (and legally taking the form of) a single pension or annuity to the end investor.

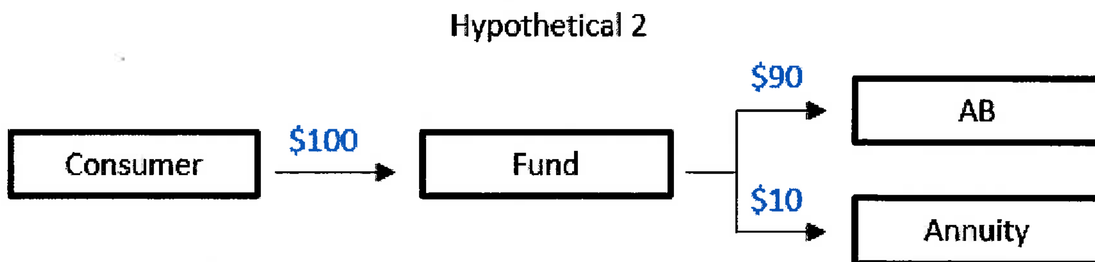
3.5 Further, the minimum benefit calculation contained in Schedule 2 of the SIS Regulations is calculated with respect to the "purchase price", which itself is defined as being the "total amount paid as consideration to purchase the income stream". This presents an issue in the case of Composite Products which are treated as a single product. There is no allowance for the fact that some of the initial purchase price is applied (not by the recipient but by an intermediary, typically the superannuation fund trustee), to purchase an asset that will produce a separate and very different type of income stream.

3.6 The implications of this can be demonstrated with 2 hypothetical situations.

3.7 **Hypothetical 1**: take a consumer aged 65, with a life expectancy of 85 and with $100 to spend. The consumer would like to purchase a product which provides her with both an account based product (for a time period commensurate with her life expectancy), and a DLA, designed to start making benefit payments if she reaches 85. The consumer purchases 2 products – an account based income stream ($90), purchased through her superannuation fund, and a DLA purchased directly by the consumer ($10). Under the minimum payment amount requirements in Schedule 7, the minimum payment for the account based product would be calculated by reference to the $90 only.



3.8 **Hypothetical 2**: another consumer wants to purchase a single product through her superannuation fund, which has two "aspects" so to speak. The consumer purchases the product for $100 from the superannuation fund, $90 of which is applied by the superannuation fund towards an account based benefit, and $10 towards the purchase of a DLA. Again, the DLA is designed to start making benefit payments if she reaches 85. Under the minimum payment amount requirements in Schedule 7, the minimum payment for this product would be calculated by reference to the $100, rather than the $90 actually allocated to the account based benefit aspect of the product. Under this scenario, even though the resulting products acquired by the consumer are functionally the same, the consumer will be forced to withdraw a greater proportion of their account balance each year under the minimum withdrawal rules.

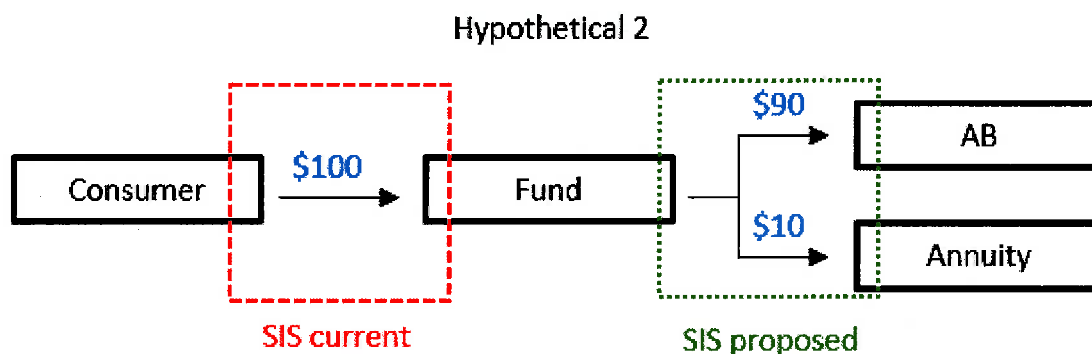


3.9 In each hypothetical situation, the consumer is trying to achieve the same outcome (namely, acquiring a deferred lifetime income stream to protect against the possibility of living beyond their life expectancy). However the consumer in Hypothetical 1 has an advantage, in that the minimum benefit payments to be paid out of the account based income stream are calculated by reference to the $90, rather than the $100. We submit that this distortion should be addressed by allowing a composite product to be assessed by looking at each of its component parts separately.

3.10 We also note that failing to treat the Composite Product as having separate, component parts may lead to unintended outcomes. If the Composite Product is treated as a single account-based pension, then there will be no requirement to pass all of the income payments generated by the underlying annuity through to the investor. Rather, the requirement will only be to satisfy the minimum payment standards which require payment of a percentage of the account balance from time to time.

Proposed Solution

3.11 Currently, a Composite Product such as that discussed in Hypothetical 2 above is viewed as a single product by the SIS Regulations. Rather than focusing only on the product terms that exist between the superannuation fund trustee and the consumer, a solution would be to increase flexibility in the classification of Types. In effect, this means a shift in focus from the end stage of the product, as provided to the consumer, to an examination of the constituent parts of the product. In the case of Hypothetical 2, this would mean a shift in focus as illustrated below:



3.12 We understand that the Draft Regulations have attempted to address this issue under item 1, where regulation 307-200.05 of the *Income Tax Assessment Regulations 1997* (Cth) ("**Tax Regulations**") is amended by allowing for "an amount that supports the superannuation interest" to be treated as a separate superannuation interest. Further, the Explanatory Memorandum to the Draft Regulations ("**Draft EM**"), under the heading "Hybrid income streams", notes that:

> *"...interests in the new income streams could still be offered as an investment option for, or as a separate interest as an add-on to, an interest in an income stream meeting the existing standards... an individual with an account based pension could request that their fund trustee purchase a deferred annuity as part of the investment strategy of the fund"*

3.13 In our view, the amendment to the Tax Regulations does not adequately address these issues. Notwithstanding that the amendment to the Tax Regulations may clarify the situation with regards to the valuation of income streams for tax purposes, this amendment does not act upon the SIS Regulations, which have, as their focus, the annuity or pension acquired by the individual rather than the application of the purchase price for the product by the product issuer.

3.14 The example in the Draft EM describes the situation in Hypothetical 1 above – the consumer must effectively purchase 2 products. Such an approach does not address the issue, which is the inability of providers to provide a ***single*** product, under one contract between a provider and consumer, which complies with the SIS Regulations.

3.15 To address this, we would suggest an amendment to allow a single Composite Product to be deemed to be compliant with the SIS Regulations by virtue of each of its constituent parts being compliant with a Type as specified in the SIS Regulations.

3.16 To effect this, we propose subregulation 1.06C be inserted into the SIS Regulations:

> "***1.06C***
>
> *A benefit that consists of separately identifiable components (whether corresponding to an underlying asset that funds the benefit or otherwise) is taken to be an annuity or pension for the purposes of the Act if each of the components would, if provided separately from the other components, be taken to be an annuity or pension for the purposes of the Act and for this purpose, the provider of the benefit must apportion the purchase price between each of the components and take such other steps as may be necessary to allow each of the components to be assessed for compliance with any applicable standard referred to in Regulations 1.05, 1.06 or 1.06A.*"

3.17 This approach allows for one or more Types of product to be incorporated within a single product. The proposed amendment is not intended to disturb the additional categories, and provides clarity on the application of the minimum payment requirements in the SIS Regulations.

4 Life expectancy concepts - "remaining life expectancy" minus one

Issue

4.1 The formula for "remaining life expectancy", after taking into account the "life expectancy period", age at commutation and primary beneficiary's age as the "retirement phase start day", then takes the resulting figure and subtracts one.

4.2 We understand that the subtraction of one at the end of the formula ensures that, following the 14 day grace period, a consumer cannot commute their product in the period up until the first anniversary and obtain the full "access amount".

4.3 However, the effect is also that a customer's maximum payment will reach zero one year prior to them reaching their life expectancy age. In Example 1.1 in the Draft EM, Hector's life expectancy is 19 years from age 65. As Hector purchased the product on his 65th birthday, his expected age at death is 84 years. However, on the day Hector turns 83, Hector's maximum payment is nil. Accordingly, Hector will receive no payment in his expected final year of life.

4.4 This feature is likely to be confusing to customers and introduces complexity to the formula for determining the maximum commutation amount.

4.5 Challenger has proposed an alternative methodology which seeks to address the concern identified at paragraph 4.2 above. The alternative methodology and reasons for it will be set out in Challenger's submission to Treasury. We have prepared an alternative draft definition designed to give effect to Challenger's proposal.

Solution

4.6 We recommend that the definition of "remaining life expectancy" be redrafted as follows:

> *"**remaining life expectancy**", for a benefit supported by a superannuation interest (within the meaning of the 1997 Tax Act), means, at the time of commutation, the period remaining from that day to the last day of the life expectancy period for that benefit, rounded up to the nearest whole month, divided by 12.*

5 Primary beneficiary concept in reversionary pension context

Issue

5.1 The Draft Regulations define "life expectancy period" by reference to "the number of years in the complete expectation of the life of the *primary beneficiary* of the benefit" (emphasis added).

5.2 We understand, from our discussions with Challenger, that the majority of annuity products purchased are joint products, which provide for annuities to both a primary and a reversionary beneficiary and that the customer (and therefore the "primary beneficiary") is more likely to be the husband than the wife. Basing these rules only on the life expectancy of the primary beneficiary distorts the calculation and does not reflect the commercial reality that for a joint pension, the duration of both lives are relevant to the value of the pension.

Solution

5.3 We submit that the definition of "life expectancy period" should be redrafted as the greater of the life expectancy periods of the primary **and** reversionary beneficiaries. The use of life expectancy periods that take into account the longer of a primary beneficiary and any reversionary beneficiary is a long-established principle for income tax purposes as discussed below.

5.4 Section 27H of the *Income Tax Assessment Act 1997* calculates the amount of assessable income arising to an annuitant each year by reducing amounts derived under the annuity by deductible amounts which represent a portion of the original purchase price. Relevantly, subsection 27H(2) prescribes a formula for calculating the annual deductible amount, which spreads the total purchase price over a period of years defined as the "relevant number". The "relevant number" is defined in subsection 27H(4) as follows:

> *"(a) where the annuity is payable for a term of years certain – the number of years in the term;*
>
> *(b) where the annuity is payable during the lifetime of a person and not thereafter – the life expectation factor of the person; and*
>
> *(c) in any other case – the number that the Commissioner considers appropriate having regard to the number of years in the total period during which the annuity will be, or may reasonably be expected to be, payable."*

5.5 For annuities with reversionary beneficiaries, paragraph (c) applies. The requirement to have regard to the number of years in the total period during which the annuity will be payable means that where a reversionary beneficiary's life expectancy exceeds the primary beneficiary, it is the longer period that is used as the relevant number. This was confirmed in the Explanatory Memorandum to the *Income Tax Assessment Amendment Act (No.3) 1984*, which included the following examples:

> *"…the Commissioner of Taxation is to take into account the number of years in the total period during which it is reasonable to expect the annuity to be payable. For example, if an annuity is payable to one person for his lifetime, who under the Life Tables has a life expectation of, say, 11 years from the time the annuity commences to be payable and, after his death, to his son, aged 5 at the time when the annuity commences to be payable, until the son reaches 21 years of age, then it would generally be reasonable to expect that the annuity will be payable for 16 years. Similarly, if an annuity is payable firstly to a man with a life expectation of 18 years from the time the annuity commences to be payable and on his death to his present wife who has a life expectation of 25 years from that time, then generally it is reasonable to expect that the annuity would be payable for 25 years. Other factors may, of course, require a variation to the general expectation."*

5.6 The definition of "relevant number" was amended (in the *Income Tax Assessment Act 1936* (Cth)) in 1985 (after the above Explanatory Memorandum commentary). However, the requirement to take into account the total period during which the annuity is reasonably expected to be payable was not changed.

6 Death of primary beneficiary during deferral period

Issue

6.1 The Draft Regulations appear to have the effect that no benefit can be paid to a reversionary beneficiary should the primary beneficiary die during the deferral period since:

(a) Reg 1.06A(3)(a) provides that no payment can be made before the primary beneficiary satisfies certain conditions of release that involve being alive (such as attaining the age of 65) which suggests that if the primary beneficiary dies before satisfying any of those conditions, no payments could ever be made; and

(b) The "retirement phase start day" also depends on the primary beneficiary satisfying certain conditions of release that involve being alive and so the concept does not appear to work if the primary beneficiary dies before then.

6.2 This feature is not explained in the Draft EM and the policy rationale for it is not explained. If reversionary benefits are permitted for immediate annuities we see no policy reason for the intervening death of the primary beneficiary during the deferral period to result in forfeiture of the reversionary pension. This seems a harsh requirement that would make a deferred product potentially unappealing to those wishing to provide a reversionary benefit for their spouse.

6.3 The premature death of the primary beneficiary would not result in the reversionary beneficiary becoming the primary beneficiary for regulatory purposes, and the reversionary annuity could commence on the expected payment commencement date for the DLA.

7 "Unreasonably deferred"

Issue

7.1 Regulation 1.06A(3)(c) of the Draft Regulations requires that, under the governing conditions, "the amount of benefit payments is determined using a method that ensures that those payments are not unreasonably deferred after they start," with a number of examples listed.

7.2 We agree with the statement in the Draft EM, that "it is unlikely providers would be incentivised to offer such products". In addition, there is little incentive from a consumer's point of view: the risk of death, combined with maximum limits on benefit payments over time, removes much of the incentive to purchase a product with payments structured in this way.

7.3 The requirement does however impose additional cost on a Provider, as any new product (or, indeed, variation to an existing product) will require a determination as to compliance. While in many cases, determining that the requirement has been satisfied may be straightforward, there will inevitably be product features that give rise to some uncertainty. It would be beneficial to incorporate a mechanism for product issuers to be able to achieve greater certainty in this respect through some kind of ruling or determination by a regulator.

7.4 As the unreasonable deferral requirement is proposed for inclusion in the SIS Regulation, it would be expected that the relevant regulator would be APRA. That said, given the tax implications of compliance or otherwise with the pension or annuity standards within the SIS Regulations, the ATO is likely to have an interest in the interpretation of this concept

KING&WOOD
MALLESONS

Proposed Solution

7.5 If APRA is considered the appropriate regulator to make this assessment (and in practice, we assume it would consult with the ATO in doing so), then we would suggest that the following be inserted at the end of draft Regulation 1.06A(3)(c):

> *provided however that the Regulator may make a determination in relation to a particular superannuation income stream or superannuation income streams of a particular kind that, for the purposes of this subregulation 1.06A(3)(C), a proposed method of determining benefit payments does not result in benefit payments being unreasonably deferred*

Such an insertion would remove much of the uncertainty around the concept, creating comfort for providers, and reducing costs of compliance, thereby reducing costs passed on to consumers.

Yours sincerely

Ruth Stringer | Partner
King & Wood Mallesons
T +61 2 9296 2567 | M +61 408 117 109
ruth.stringer@au.kwm.com

This communication and any attachments are confidential and may be privileged.

ATTACHMENT C

Proposed integrity measure to be added to the maximum commutation value draft 1.06B regulations to allow the removal of LE – 1 year requirements.

New definition of ‘remaining life expectancy’ to be:

*“**remaining life expectancy period**”, for a benefit supported by a superannuation interest (within the meaning of the 1997 Tax Act), means, on any day, the period remaining from that day to the last day of the life expectancy period for that benefit, rounded up to the nearest whole month, divided by 12.*

Therefore the maximum commutation formula remains:

$$= \left[\frac{\text{Access amount for the income stream at the time of the commutation}}{\text{Life expectancy period for the income stream}} * \text{Remaining life expectancy} \right] - \text{Previously commuted amount}$$

Example 1
Commutation time = 350 days (or 11 complete months) into the first year of the product

Access amount = $100,000
LE (rounded down) = 20 years (240 months)
Life expectancy remaining = 229 months (228.5 months rounded up)
Previous commutation = $0

= [($100,000 / 20) * (229/12)] - $0
= [($5,000 * 229/12)] - $0
= $95,416.66

Example 2
Commutation time = 10 years and 5 days (or 120 complete months) into the product

Access amount = $100,000
LE (rounded down) = 20 years (240 months)
Life expectancy remaining = 120 months (119.83 months rounded up)
Previous commutation = $0

= [($100,000 / 20) * (120/12)] - $0
= [($5,000 * 10)] - $0
= $50,000

Example 3 (with partial commutation)
Commutation time = 10 years (or 120 complete months) into the product

Access amount = $100,000
LE (rounded down) = 20 years (240 months)
Life expectancy remaining = 120 months

Previous commutation = $5,000

= [($100,000 / 20) * (120/12)] - $5,000
= [($5,000 * 10)] - $5,000
= $50,000 - $5,000
= $45,000

Drafting comments

- It is important that the life expectancy remaining number of months is **rounded up** to:
    - follow the 'true return of capital' with a payment frequency of monthly (ie it is only after the monthly payment that the capital should effectively reduce); and
    - ensure a simple message to retirees that there is a reducing capital schedule reaching zero at life expectancy (as opposed to reaching zero at life expectancy less one month if it was rounded down).
- This now addresses both our issues with the proposed draft formula, being the '-1 year' and the fact it didn't take into account frequency of payment (which will generally be monthly).

Example 4 - Maximum commutation values from inception to the end of life expectancy

Assumes

- Access amount = $100,000
- LE (rounded down) = 20 years (240 months)
- LE remaining formula uses months **rounded up**.
- Numbers are end of month (after monthly income payment)

Table 1. Maximum commutation amount

Month	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
1	$99,583	$94,583	$89,583	$84,583	$79,583	$74,583	$69,583
2	$99,166	$94,166	$89,166	$84,166	$79,166	$74,166	$69,166
3	$98,750	$93,750	$88,750	$83,750	$78,750	$73,750	$68,750
4	$98,333	$93,333	$88,333	$83,333	$78,333	$73,333	$68,333
5	$97,916	$92,916	$87,916	$82,916	$77,916	$72,916	$67,916
6	$97,500	$92,500	$87,500	$82,500	$77,500	$72,500	$67,500
7	$97,083	$92,083	$87,083	$82,083	$77,083	$72,083	$67,083
8	$96,666	$91,666	$86,666	$81,666	$76,666	$71,666	$66,666
9	$96,250	$91,250	$86,250	$81,250	$76,250	$71,250	$66,250
10	$95,833	$90,833	$85,833	$80,833	$75,833	$70,833	$65,833
11	$95,416	$90,416	$85,416	$80,416	$75,416	$70,416	$65,416
12	$95,000	$90,000	$85,000	$80,000	$75,000	$70,000	$65,000

ATTACHMENT C

Month	Year 8	Year 9	Year 10	Year 11	Year 12	Year 13	Year 14
1	$64,583	$59,583	$54,583	$49,583	$44,583	$39,583	$34,583
2	$64,166	$59,166	$54,166	$49,166	$44,166	$39,166	$34,166
3	$63,750	$58,750	$53,750	$48,750	$43,750	$38,750	$33,749
4	$63,333	$58,333	$53,333	$48,333	$43,333	$38,333	$33,333
5	$62,916	$57,916	$52,916	$47,916	$42,916	$37,916	$32,916
6	$62,500	$57,500	$52,500	$47,500	$42,500	$37,500	$32,499
7	$62,083	$57,083	$52,083	$47,083	$42,083	$37,083	$32,083
8	$61,666	$56,666	$51,666	$46,666	$41,666	$36,666	$31,666
9	$61,250	$56,250	$51,250	$46,250	$41,250	$36,249	$31,249
10	$60,833	$55,833	$50,833	$45,833	$40,833	$35,833	$30,833
11	$60,416	$55,416	$50,416	$45,416	$40,416	$35,416	$30,416
12	$60,000	$55,000	$50,000	$45,000	$40,000	$34,999	$29,999

Month	Year 15	Year 16	Year 17	Year 18	Year 19	Year 20
1	$29,583	$24,583	$19,583	$14,583	$9,583	$4,583
2	$29,166	$24,166	$19,166	$14,166	$9,166	$4,166
3	$28,749	$23,749	$18,750	$13,750	$8,750	$3,750
4	$28,333	$23,333	$18,333	$13,333	$8,333	$3,333
5	$27,916	$22,916	$17,916	$12,916	$7,916	$2,916
6	$27,499	$22,499	$17,500	$12,500	$7,500	$2,500
7	$27,083	$22,083	$17,083	$12,083	$7,083	$2,083
8	$26,666	$21,666	$16,666	$11,666	$6,666	$1,666
9	$26,249	$21,249	$16,250	$11,250	$6,250	$1,250
10	$25,833	$20,833	$15,833	$10,833	$5,833	$833
11	$25,416	$20,416	$15,416	$10,416	$5,416	$416
12	$24,999	$20,000	$15,000	$10,000	$5,000	$0

Note: The table above is an extract from our annuity quoting software that provides retirees with their maximum withdrawal amount during the life of their lifetime annuity (some numbers have been slightly rounded by the software).