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9th March 2005

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

REVIEW OF PENSIONS IN SMALL SUPERANNUATION FUNDS

Dear Sir,

In accordance with the publicly announced forthcoming enquiry on the above matter and the call for submission from interested parties, I ask you to take account of the comments and submissions that follow. Recommendations are given throughout the text and are numbered to highlight them.

My view is that the current pension system is grossly inadequate, and in the longer term fiscally unsustainable, because of the increasing number of retirees who will be partly or wholly dependent on the social security system. MAJOR changes to the whole system are needed, not just minor adjustments to the legislation controlling SMSFs. There should also be changes to regulations controlling the larger funds and particularly changes to taxation, and additional encouragement (carrot and stick) should be incorporated to encourage more people to rely on self-funded pensions rather than the social security system.

**Background**

As background to my submissions I advise that I am a trustee of a Self-Managed Superannuation Fund (SMSF) and a pension beneficiary of that fund, and I and my wife (the other trustee and member) are fully independent of the social security system and intend to remain so.

**Retirement Incomes Policy Objectives**

These are fundamentally flawed in that the present level (9%) of compulsory contributions is insufficient to provide fully for non-social security pensions. This inadequacy is exacerbated by (a) taxation of all contributions (b) taxation of income and

capital gains within the fund at the accumulation stage, and (c) by the ludicrous system of allowing tax-free lump sum withdrawals, and (d) by the present actuarial system which is designed to provide the maximum tax in the shortest possible period and in so doing ensures that about 50% of retirees could run out of money before they die.

To meet Retirement Incomes Policy Objectives the following changes should be made.
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1. The current compulsory superannuation charge should be increased to at least 10%.
2. The standard 15% contributions tax should be abolished. However the contributions surcharge on high-income individuals should be maintained (at say 15%) to prevent abuse of the system. However it should become a TAX and be deductible from tax on pensions, and this recognition of the surcharge as a tax should be made retrospective.
3. All income and capital gains within the fund should be exempt from the current 15% tax **except where the pension RBL is exceeded**. The 15% tax would then apply. This should apply to all pension accounts , not just those in SMSFs.
4. The right to withdraw tax-free lump sums from funds accumulated through deductible contributions should be abolished. Only funds contributed as undeducted contributions should be withdrawable as tax-free lump sums on retirement. As at present, tax would not apply to funds to be taken as an income stream from an Allocated Pension, "Complying Pension", etc, or for purchase of a pension or annuity through an APRA-approved pension provider. (This abolition of tax-free withdrawals might be unpopular, but is fundamental to the integrity of the system).
5. In addition to 4 above, the upper limits for the income test and assets tests should be reduced (by about 1/3 ?) Again, this would not be popular, but in the long term will be necessary. All of the above items would significantly increase the funds available to provide pensions.
6. The whole concept of "Compulsory Cashing" of pension funds at 65 should be amended, and become Compulsory Pension Stream Commencement, with age variations depending on whether the individual was in full time employment or not, but mandatory pension commencement eg by age 70.

**<u>SMSF Issues</u>**

RBL Compression should be dealt with under the proposals in 5.2.1 of your discussion paper.

Estate planning issues within an SMSF should be dealt with on an "after death" basis with appropriate taxes, NOT by restricting pension options. Actuarial guidelines which ensure that the purchase price of a pension is wholly converted into income are a complete farce, and only put a strain on the social security system and create personal misery through ensuring that approximately 50% of people, ie those who outlive their life

expectancy, could also outlive their pension. Adding 5 years to life expectancy, as per your 5.3.1, does little to help a fundamentally flawed system.

7. The residual value of the fund after death should revert to other members, tax-free provided it stays within the superannuation fund and is within the deceased member's RBL. Any funds in excess of the RBL  should be withdrawn and taxed in the same way as other assets at death, (and in the same way as any residual benefit in an APRA fund would be treated) thus ensuring the tax integrity of the SMSF system.

The aim of all self-funded retirees, and the system should encourage this not obstruct it, should be to be fully self-supporting on a lifetime pension of some sort (NOT a life expectancy pension), whether provided by the SMSF of be a third party APRA-approved fund. **Within a SMSF the only way that a lifetime pension can be organized with a reasonable degree of certainty, is for pension payments to be fully covered by fund income**( ie from dividends and interest) from investments with sufficient growth and income growth potential to counteract the effects of inflation.

8. Pension Valuation Factors and Allocated Pension Payment Factors, particularly the minimum ones, need to be amended to allow for this and particularly to allow for the current low interest and dividend yield rates. This appears to be envisaged in your section 5.3.4. The maximum figures also need to be reduced to prevent people cashing out too quickly pension, and then reverting to a social security

9. Because it is unlikely that a SMSF would have sufficient reserves, Defined Benefit Pensions should NOT be payable from a SMSF – UNLESS the fund can demonstrate that it has the capability to fund the proposed pension. Any costs incurred in demonstrating this should of course be a cost to the fund not to the administrator (whether ATO or APRA) of the fund.

Similarly, all of the pension options discussed in section 5.4 of your paper are fundamentally inappropriate for a SMSF – unless they can be augmented by some form of longevity insurance provided by a third party, eg an APRA-approved fund. While longevity insurance is not a commonly publicized product it could help to provide alternatives to the most satisfactory way of providing a lifetime pension from a SMSF ie from ongoing dividend and interest income. However, even this is extremely difficult, if not impossible, with the current escalating Payment Factors.

10. Thus the revision of the Payment Factor tables is particularly important in that the minimum pension payments should NOT be based on illusory actuarial tables, but on the dividend yields and interest rates which are readily achievable in the market of the day, and should NOT escalate with age in a way that ensures that anyone living significantly beyond their life expectancy will run out of money.

10a (Addendum) The old style Complying Pension should be reinstated. Minor amendments may be necessary to prevent abuse, such as through RBL compression. It should have flat, non age-related, minimum and maximum pension withdrawal rate tables

prescribed by APRA/ATO and the need for individual funds to have actuarial assessment should be abolished. The Complying Pension should become the standard pension rather than the Allocated Pension which is open to abuse through capital withdrawals etc. The only capital withdrawals which should be allowed, should be a part (say 50%) of undeducted contributions. ALL pension assets should count 100% towards the assets test for determining eligibility for a social security pension. If deducted amounts are allowed to be withdrawn, they should (a) be fully taxed and (b) should continue to be counted as an asset for social security pension determination (i.e. "double-dipping" should be discouraged. If money has been saved for a pension, with appropriated tax advantages, it should be taken as a pension.)

**Broader Issues**

This enquiry is focused on SMSF pensions, but it should also consider the integrity, or current lack of it in the larger APRA-controlled public funds including disclosure of fees, particularly more simplified transparent management fees and undisclosed exit fees.

There are still products around, but not now marketed, that have exit fees which, after several years, can still exceed 50% of the members' balance. Members have been locked in for years to some1990s funds with high management expense ratios (MERs), negligible growth, and with no viable exit route other than waiting for maturity.

11. Such horrendous exit fees should be made illegal, and should be made illegal retrospectively.

12. Similarly MERs in the larger fund should be controlled by legislation – say to 2%.Most funds could live with this. UK, I believe has legislated for a 1% maximum, but I believe this is commercially unrealistic. Exit fees should be controlled at a maximum of 5%.

13. Finally, the supervision of SMSFs by the ATO should be scrutinized, and probably abolished in favour of a separate SMSF division within APRA. The ATO has a clear conflict of interest in this regard and has proved it at least once with its attempt to outlaw the perfectly legal tax-free withdrawal and recontribution strategy. ("Two legal= one illegal" according to a headline in the Finanacial Review.)

Yours sincerely,

D.C. Gellatly