SUBMISSION:

FINANCIAL PLANNING ASSOCIATION OF AUSTRALIA LIMITED (FPA)

TO

THE TREASURY

General Manager,
Superannuation, Retirement and Savings Division

REVIEW OF THE PROVISION OF PENSIONS IN SMALL SUPERANNUATION FUNDS

response to January 2005 Discussion Paper

March 2005

Review of provision of pensions in small Super funds

FPA Response to Treasury Discussion paper

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I. Submission purpose and structure

Purpose

This Submission is the FPA’s response to Treasury’s January 2005 Discussion Paper concerning its Review of the provision of pensions by small superannuation funds.

Structure

- Section II below provides brief Background to the Review.
- Section III comments on the Discussion Paper and emphasises that it is a first step in outlining and considering the options, and that any resultant reform to the superannuation system should only be taken after an exhaustive review of each option’s respective ‘pros & cons’ and after extensive consultation with stakeholders.
- Section IV specifically responds to the proposals raised in your Discussion Paper.
- Section V reiterates key points made in earlier submissions and in discussions with the Government.
- Section VI offers succinct concluding comment.

II. Background

1. SMSFs are an important and popular vehicle for those providing for their retirement. Many chose them in order to gain more **flexibility** and **control** of their retirement funds.
2. An option for SMSF members is to have their fund run a defined benefit pension.[1] Whilst only a relatively small proportion of SMSF members chose this option, many have based their retirement plans around having it.
3. Treasury had concerns that:
   - some SMSF members with relatively high superannuation balances structure and use their SMSF to minimise tax[2];
   - the estate planning benefits of SMSFs running defined benefit pensions mean 'tax deferral'.
4. Treasury recommended blocking the option of SMSFs running defined benefit pensions, and the Government adopted this recommendation in its May 2004 Budget.
5. Many retirees and potential retirees were surprised at the decision. There had been minimal consultation with industry, resulting in little or no consideration of the decision's potential negative consequences, or that there might be other ways of achieving the Government's legitimate anti-tax avoidance etc aims **without** compromising Choice (of fund and income stream) – hitherto a cornerstone of the Government's superannuation Policy.
6. The decision threw the plans of many retirees into chaos, including long-term plans developed over a number of years. (Those who had already made the decision to set up an SMSF to run a defined benefit pension couldn't simply rethink their strategy without much extra effort and cost. The confusion was compounded as it took some months to clarify the relevant 'grandfathering' provisions.) The decision also undermined public confidence in superannuation – which now seemed more subject to regulatory risk.
7. The Government received many submissions (including the FPA's June 2004 submission) arguing against the decision, noting its unintended negative consequences and that industry consultation would have raised alternatives which could equally have met the Government's legitimate anti-avoidance aims, but without the negative impacts.
8. In June 2004, the Government announced this Review to be conducted by Treasury. (It also extended the period in which existing SMSFs could offer defined benefit pensions.) Initial submissions were due in October 2004, and the FPA's submission reiterated many of its earlier points and asked Treasury to address avoidance and other concerns in more productive ways and to take a broader and longer-term approach.

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[1] Some of these are also known as 'lifetime' pensions, but defined benefit pensions can also include fixed term pensions.

[2] A smaller number use the defined benefit pension to 'double dip' into the aged pension - although this has been made more difficult in recent years. As noted in our previous submission to you, concern with 'double-dipping' into the aged pension was largely addressed via the cut in the assets test exemption from 100% to 50%.

III. The Discussion Paper - a first step

a) We welcome the Discussion Paper’s outline of options, but have some comments

The FPA:

1) Welcomes the Paper’s acknowledgement that some chose SMSFs for the legitimate reason of having more flexibility and control of their retirement funds.
2) Welcomes that the Paper outlines the ‘pros & cons’ of small funds offering defined benefit pensions and the alternatives to stopping SMSFs from running these pensions.
3) Welcomes the acknowledgement that there might be other – more positive – ways of addressing tax-avoidance related and prudential-related concerns about SMSFs offering defined benefit pensions.
4) Particularly welcomes the acknowledgement that the problem of compression of the Reasonable Benefit Limit (RBL) – see ‘E’ – could largely be overcome by updating the RBL tables to reflect longer life-spans - so that it is more difficult to use RBL compression to avoid tax.
5) Agrees that the key strategies canvassed in the Paper (develop new rules for the provision of defined benefit pensions; modify existing pension products; introduce new pension products) could be implemented separately or in combination.
6) Agrees that, if new rules are developed for the provision of defined benefit pensions, they would need to be simple and transparent and operate in a way that minimised compliance costs.
7) Agrees that any measures to address perceived ‘estate planning’ problems would need careful drafting so that they avoided unintended consequences and are not easily circumvented through restructuring pension arrangements.
8) Suggests that, when Treasury’s review reaches the stage of considering the options, the industry should be consulted to try to identify and minimise an option’s potential negative unintended consequences.
9) Suggests that, whatever option the Government eventually selects, it should offer the flexibility to run a defined benefit pension for dependants such as handicapped / disabled children in the family.

Whilst the Discussion Paper succinctly outlines the relevant issues and alternatives, however, the discussion of policy alternatives is sometimes limited and there remains a need for a longer-term and whole-of-government approach.

Particularly, we regret that the discussion of issues related to estate planning tends to be ‘compartmentalised’, with little acknowledgement of our key points (see ‘F’) that:

1. It is understandable that these pensions’ estate planning benefits are attractive to many.
2. Treasury cannot quantify and may have overstated any relevant ‘tax deferral’ impacts.

3. The estate planning features involve some longer-term 'keeping money in superannuation' advantages.

b) It will take time to 'work through' the options, but reform should be well-considered

The advantages and disadvantages of available options will take time to 'work through'; but it is better that this is done thoroughly and achieves positive outcomes.

As noted in our 'reconfirmed points' below:

I. Superannuation's public image has already been tarnished by structural complexity and ad hoc changes.

II. Announcing sudden 'changes of direction' without consultation and / or 'working through' the impacts can not only compromise policy making and community goodwill but public confidence and investment in superannuation.

It is therefore imperative that further significant changes to the superannuation regime are only made once all the issues and options (and their respective pros & cons) have been thoroughly canvassed in consultation with stakeholders.

The review of pensions provided by small superannuation funds must be a comprehensive analysis of all the issues and policy alternatives. Otherwise, there will be negative consequences from a range of perspectives:

a. to the plans of many ordinary Australians wanting to manage their own fund and run a defined benefit pension
b. to superannuation's public image and acceptability
c. to the trust of the electorate and of business that the Government:
    - 'practices what it preaches' (in terms of commitment to Choice and to people planning for and investing in their retirement)
    - commits to a policy process involving looking at the options and consulting with stakeholders
    - considers the broader perspective and the longer-term.

Also, any reform which emerges from this Review should be:

1) Comprehensive and delivered 'in one consistent package' or in discernible and logical stages, after such considered review.
2) Clear in its purpose and delivery, including in transitional arrangements.
3) Well-communicated to those on whom it impacts, so that ordinary Australians can understand reform's rationale and likely impacts and can plan (including by seeking professional financial planning advice) accordingly.

IV. Comment on specific proposals raised in your Discussion Paper

In the next section of our Submission (Section V), we reiterate key points made in earlier submissions, including general comment on RBL compression and estate planning.

In this section (Section IV), we **specifically respond** to proposals raised in your Discussion Paper.

a. RBL Compression

Purchase Price Valuation

Your Discussion Paper (5.2.1) raises the proposal that defined benefit pensions be valued for RBL purposes by the purchase price less undeducted contributions (UDC) instead of the current formula.[3]

FPA Position: The FPA would **support** this measure which ensures the RBL valuation of lifetime pensions is brought into line with other 'purchased' pensions. The purchase price should include the value of any segmented solvency reserves used to back the pension.

Update Pension Valuation Factors

Your Discussion Paper (5.2.1) raises the proposal that the pension valuation factors be updated – similarly to the Family Law factors for superannuation.

FPA Position: The FPA would **support** this measure – as it would ensure 'non-purchased' pensions (eg, those paid from a public service defined benefit fund) are valued in the same way as other income streams. We do not believe, however, that the Family Law factors are suitable for this purpose. Industry consultation can work towards a more appropriate factor.

Change capital value formula to remove RBL impact on UDCs

Your Discussion Paper (5.2.1) raises the proposal that the capital value formula be changed to remove the RBL impact on UDCs.

FPA Position: The FPA would **support** this measure – which would ensure that 'non-purchased' pensions are valued in the same way as other income streams.

[3] This would be similar to allocated pensions and purchase fixed terms (TD 2000/28 & 29).

b. Estate Planning

Prescribed initial payment factors **or** portability levels

Your Discussion Paper (5.2.2) raises the proposal that pension design standards could prescribe initial payment factors or portability levels.

FPA Position: Given that each individual's circumstances are different, the FPA would not like to see any changes that are overly prescriptive. As mentioned in this and in previous FPA submissions, we support measures to provide **better guidance** to actuaries in relation to determining the level of pension payments. This will provide a more consistent outcome for pension members and address prudential and estate planning concerns.

Indexation caps

Your Discussion Paper (5.2.2) raises the proposal that pension design standards could prescribe indexation caps.

FPA Position: The FPA would support the introduction of consistent indexation caps to all defined benefit pensions. At the moment, the caps are different for complying lifetime, complying fixed term and commutable lifetime (or 'flexi') pensions. The Centrelink indexation caps are not consistent with the SIS definition for complying pensions. However, the caps should not be too restrictive.

Actuarial guidance to ensure all purchase price is paid as income

Your Discussion Paper (5.2.2) raises the proposal that pension design standards could prescribe actuarial guidelines that ensure all purchase price of the pension is paid as income.

FPA Position: The FPA believes that this is a reasonable test to apply and one which Centrelink applies to complying income streams paid from small funds. But a review of the method used by Centrelink should be undertaken to ensure that it is appropriate for use on a wider scale and allows flexibility of investment choice.

Excess reserves to be paid out via one-off adjustment to income or additional indexation rate

Your Discussion Paper (5.2.2) raises the proposal that excess reserves be paid out as additional pension payments with a one-off adjustment to annual payments or an additional indexation rate applying to a pension where the reserves exceed a certain level.

FPA Position: The FPA has concerns about the detail of this measure, especially around the definition of 'excess reserves'. Reserves are there to ensure that solvency and longevity risks can be managed for an investment portfolio that fluctuates in value. We would not like to see a large portion of the reserve forced out as income – only to find that the actuary determines that the fund has failed the high probability and / or minimum solvency tests in subsequent years.

Restrict residual payable on commutation

Your Discussion Paper (5.2.2) raises the proposal that pension design standards restrict the amount of residual that could be paid from a pension on commutation: that residual capital value pensions could be restricted to pensions paid up to the compulsory cashing age of 65; or that minimum draw down rules could apply to these pensions based on income that would be received from a lifetime annuity.
FPA Position: The FPA believes that individuals should have the flexibility to **choose** a residual capital value. Applying minimum drawdown rules complicates matters. We believe that better actuarial guidelines can achieve the same outcome.

Limit reversion to spouse or other financial dependants

Your Discussion Paper (5.2.2) raises the proposal that pension design standards could limit reversion to a member's spouse or other financial dependants.

FPA Position: The FPA believes that there are legitimate cases where a pension should be able to revert to a dependant other than a spouse (eg, a disabled child – we have emphasised the importance of this in previous submissions) and would not support measures which did not allow this.

Reserves on death of final beneficiary to be cashed out

Your Discussion Paper (5.2.2) raises the proposal that pension design standards could require any remaining reserves on the death of the **final** pension beneficiary to be cashed from the superannuation system; and that these could be paid as **pension income** to the estate of the final beneficiary.

FPA Position: The FPA strongly believes that beneficiaries should have the **choice** of receiving benefits remaining on death **in the form of a pension** rather than forcing them to 'cash out' benefits. (See 3.5 of our initial Submission to your Review.) Also, benefits from reserves currently count towards the recipient's RBL and this limits the tax concessions that a beneficiary can receive.

Tax residual capital as the small fund's 'special income'

Your Discussion Paper (5.2.2) raises the proposal that residual capital remaining in a small superannuation fund after the death of a pensioner or reversionary pensioner (outside the pension guarantee period) could be taxed as special income of the fund under section 273 of the *Income Tax Assessment Act 1936*.

FPA Position: The FPA would **not** support such a measure. We believe that taxing residual capital as special income is harsh - given the taxes that would have already applied to contributions and earnings along the way.

Tax income from surplus assets as special income

Your Discussion Paper (5.2.2) raises the proposal that, alternatively (to the option above), income from pension reserves that do not qualify for a taxation exemption

(the excess above the actuary's 'best estimate' value) could be taxed as special income.

FPA Position: The FPA would **not** support taxing income from surplus assets as special income – for the reasons outlined in response to the option above. To restate our position, we believe that the current system of taxing the income from surplus assets (above best estimate) at 15% is fair and should remain.

Tax reserves as they emerge – as per life company profits

Your Discussion Paper (5.2.2) raises the proposal that, alternatively, reserves could be taxed as they emerge - in the same way as life office profits are taxed.

FPA Position: The FPA would **not** support this measure because, apart from introducing unnecessary complexity, it would be unfair. For example, if reserves were to be taxed based on a point in time valuation of assets at year end, what may have been considered a reserve might not be 'a reserve' in the future if market prices fall.

c. Risk Management

Transfer risk from fund to pensioner and distinguish from 'guaranteed'

Your Discussion Paper (5.2.3) raises the proposal that the risk be transferred from the fund to the pensioner – in which case, defined benefit pensions provided by small funds could be renamed to distinguish them from guaranteed income stream products.

FPA Position: The FPA would **not** support this measure. We believe that small funds should be able to run a defined benefit pension backed solely by the assets of the fund. Introducing a new name only adds to the complexity of the system without achieving any value. It is potentially a backward step in assisting education activities.

Portfolio rules

Your Discussion Paper (5.2.3) raises the proposal of portfolio rules for small funds paying defined benefit pensions.

FPA Position: The FPA would **not** support the prescription of particular investment restrictions or diversification rules. SIS already requires a documented investment strategy and has a number of other investment restrictions (eg, in-house asset rules). We believe that these are sufficient and that members (trustees) should have direct control and choice over investments.

Longevity insurance (in the form of a deferred annuity)

Your Discussion Paper (5.2.3) raises the proposal that longevity insurance (in the form of a deferred annuity) could also be attached to a pension to help manage the mortality risk.

FPA Position: The FPA believes that this requires further investigation – specifically into whether there is a market for this and whether it is commercial to supply this product. We believe that the current actuarial standards for defined benefit pensions adequately address longevity risk.

d. Modified product options

Modified term for TAP

Your Discussion Paper (5.3.1) raises the proposal that the maximum pension term could be extended to cater for retirees seeking an income stream well beyond their life expectancy.

FPA Position: The FPA strongly **supports** the proposal to extend the range of terms available for a term-allocated pension. This would help to address any longevity risk concerns. We suggest that the method for achieving this should be simple and transparent (eg, a term based on life expectancy [LE] or LE less 8 years; or, if reversionary, a term up to the spouse's LE less 8 years). We would also support a measure that allows the member to refresh the term based on their new life expectancy say every 5 years when new life tables are released (without the need to commute and repurchase).

Longevity insurance for TAP

Your Discussion Paper (5.3.2) raises the proposal that a deferred lifetime annuity could be attached to a market-linked pension to insure against the possibility of a retiree living beyond the pension term.

FPA Position: The FPA believes that this proposal requires further investigation - specifically into whether there is a market for this and whether it is commercial to supply this product. We note that longevity risk concerns could be resolved with other simpler measures such as the proposal for an extended term for a TAP.

'Smooth' TAP payments

Your Discussion Paper (5.3.3) raises the proposal to 'smooth' income payments by allowing an annual payment within the range of the payments calculated under the existing payment formula for the current year and the previous year.

FPA Position: The FPA **supports** this measure – as smoothing of TAP payments helps retirees to better manage investment market volatility; and this provides an important psychological benefit to retirees when investment returns are negative.

New minimum present value factors (PVFs) for allocated pensions

Your Discussion Paper (5.3.4) raises the proposal of updating the minimum payment factors to reflect current economic and mortality assumptions.

FPA Position: The FPA strongly **supports** the updating of the factors – which have not been updated – to reflect current mortality rates – for many years.

e. New products – account based

Your Discussion Paper (5.4) raises proposed new pension designs.

FPA Position: The FPA respectfully notes that there is little detail provided on these proposed new product options. As a general comment, however, we believe that they would introduce needless complexity – when the same outcomes could be achieved through very simple modifications to allocated and term-allocated pensions.

V. FPA reconfirms key points

A) Need for a stable Super environment

1. As outlined in our earlier submissions, the FPA was concerned that the 2004 Budget decision (preventing SMSFs from running defined benefit pensions):
   - was formulated without the industry being consulted
   - would reduce Choice (see below)
   - would disadvantage those who had already chosen the SMSF route for legitimate reasons
   - confused many Australians about what superannuation options remained available and prompted many to put their retirement decisions 'on hold' until the overall superannuation position became clearer
   - caused uncertainty and anxiety amongst retirees and their financial advisers (particularly the 'small business' advisers with a significant proportion of clients near retirement age)
   - can be seen as discriminatory (given that life offices can still run these pensions) and anti-competitive
   - seems an overly aggressive way to tackle tax minimisation issues that could otherwise be addressed more positively and unquantified concerns about tax deferral.
2. We were concerned that the Budget decision might exacerbate the perception that superannuation funds are subject to regulatory risk, and this might discourage superannuation savings.
3. Our members report that many clients (even those who hadn't been planning to have an SMSF run a defined benefit pension) now appear more reluctant to invest in a system that might go through many more changes before they retire.
4. In short, ad hoc change to the superannuation regime reinforces the perception that the 'goalposts' might continue to be moved; and this is likely to damage superannuation's public acceptability and use.

B) Consultation with industry helps clarify options and their impacts

As emphasised in earlier submissions and in our discussions with the Government and its departmental advisers:

1. There is an onus on policy advisers to **ask questions** and to consult industry specialists and practitioners to better understand how things do or will work in practice.
2. Past consultation has led to **fewer** unintended negative consequences and 'ripe for exploitation loopholes' and to **better**:
   - knowledge of the realistic options and of options' pros & cons
   - policy formulation and implementation, including better drafted legislation and regulations
   - relations with the financial services industry.
3. Our association has respected the **confidentiality** of such discussion.

C) Meeting legitimate objectives without eroding Super's acceptability

1. The FPA understands that the Government:
   a. has concerns with SMSFs
   b. wants to address arrangements which:
      i. exploit superannuation tax concessions
      ii. circumvent the social security means test.
2. We support efforts to prevent superannuation arrangements being used as a vehicle to avoid tax and / or to abuse asset-test exempt pensions.
3. Whilst we respect the Government's anti-avoidance aims, however, **how** these aims are met and the stability and public acceptability of the superannuation regime are also important.
4. Whilst we acknowledge that there has been some inappropriate use of SMSFs, particularly the use of the RBL formula for lifetime pensions to allow wealthier retirees to compress RBL calculations in order to avoid tax, we believe that this problem is small and shrinking and could be tackled without compromising Choice. More of this below.

D) Importance of income stream Choice

1. It is important for Australians to be able to choose between funds **and** income streams.
2. Choice encourages people to prepare and plan for their retirement, and closing off a valid option seems inconsistent with the Government's stated Choice position.
3. Many retirees prefer a steady indexed defined benefit pension in retirement [4]; and, as noted in previous submissions, whilst we fully support the 20.9.04 introduction of market-linked pensions, we see them as **complementary to** defined benefit pensions and **not as a replacement**.

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[4] Although the new market-linked pension has many desirable features in providing flexibility and greater incentive for market performance, it also has some disadvantages vis-à-vis defined benefit pensions, including that market-linked pensions are more likely to 'run out' before the member dies and will provide a variable pension income.
As noted in our previous submissions, the three key reasons why people choose defined benefit pensions are because they want: the certainty of a predetermined income with the ability to nominate a level of indexation to help keep pace with inflation; the ability to properly diversify their investments; retention of the remaining capital for the benefit of their own family. Not all of these can be met if SMSF members wanting lifetime-guaranteed income streams are forced to purchase them from a life insurance company. For reasons outlined in our October 2004 submission to you, many would refuse to purchase these pensions from a life insurance company; and, if the only way an SMSF member could have a defined benefit pension was to buy one from a life company, retirees might choose not to use these pensions. If they did take this option, however, the insurance company retains any remaining balance (on the recipient's death) in reserve – to support obligations to other clients. Furthermore, some life companies have ceased to offer 'lifetime annuities' as they are concerned about the longevity risk posed by their client base and, therefore, about their own liquidity. If this trend were to catalyse, and SMSFs were stopped from running defined benefit pensions, there would be few if any means to secure a 'lifetime' pension.

E) Concerns about the use of Reasonable Benefit Limits (RBLs) to minimise tax

As noted in our earlier submission to you:

1. Whilst some advertising literature promotes aggressive tax planning advice (about how to minimise current and future tax on retirement savings) and whilst such strategies are against the spirit of taxation law, there are other ways to prevent the use of such aggressive strategies.
2. Most SMSFs have <$1M in assets and are therefore not being manipulated to receive pensions of $70,000pa tax free and to 'double dip'; and many related concerns:
   - were addressed by reducing the Social Security asset test exemption from 100% to 50% for new pensions
   - could be further addressed by revising / tightening the RBL calculation formula and by using 'teeth' already available in tax law.
3. It is unclear why the RBL restructuring option was not seen as a real alternative when these issues were being looked at by Treasury and government in the lead up to the 2004 Budget. The RBL tables could have been readily updated.
4. As noted in our original submission to you, there seems to be a misunderstanding that defined benefit pensions are primarily used only in SMSFs to manipulate Reasonable Benefit Limits (RBLs). However, the Budget measures did **not** change how lifetime pensions paid from any fund are valued for RBL purposes - so RBL compression is still available as a strategy. For example, someone buying a lifetime pension backed wholly by life policies could still use it. (Also, although term-certain pensions do not exploit RBL compression, they were 'caught up' by the Budget decision too.)
5. We do not want to give the impression that the FPA thinks that the RBL tables are the only way (or even necessarily a good way) to determine concessional tax rates on superannuation amounts received over an individual's lifetime. However, RBLs are the means used at this time, and adjustment of the RBL tables could address many of Treasury's concerns about the use of SMSF-run defined benefit pensions.
6. Changing the RBL formula (and bringing the RBL value on a purchased defined benefit pension into line with other purchased income streams) will largely 'fix' the tax avoidance (and revenue leakage) problem.
7. We recommend that the RBL tables be updated as soon as possible and, if they continue to be used, reviewed on a more regular basis.

F) Estate Planning issues

It is clear that Treasury sees the ability of SMSF-run defined benefit pensions to 'revert' to beneficiaries as a tax deferral problem threatening future revenue.

We note that Section 3 of your Discussion Paper emphasises that superannuation-related tax concessions are not intended to provide estate planning or wealth accumulation benefits beyond those necessary for retirement income purposes.

Whilst we understand your view that superannuation-related tax concessions should not be designed or used for wealth accumulation beyond these purposes, we re-emphasise our earlier points that:

- policy-making for one specific area is rarely able to be entirely quarantined from policy-making in other areas
- it is understandable that many people do not want amounts 'left over' in their superannuation fund to be lost to their family members
- these amounts **are** subject to tax
- preserving these amounts in the superannuation system has longer-term benefits for the society as a whole.

As noted in our October 2004 submission to your Review:

1. The provision of benefits for the deceased member's dependants is a 'sole or primary purpose' for which a superannuation fund is (and **must** be) operated.
2. With defined benefit pensions, the funds used to purchase the income stream are transferred into the superannuation fund reserves and then invested to meet the pension obligations – which cease on death of the owner or 'reversionary', with the balance passed to beneficiaries (ie, other super fund members) through the **preserved** superannuation system. (This transfer process does **not** apply in the same way with term-certain defined benefit pensions – which neither defer tax to the next generation nor defeat the RBL.)
3. Treasury and the ATO see this as having negative tax deferral implications, but have not quantified the perceived revenue leakage.

4. We believe that the tax deferral concern is exaggerated.
   - defined benefit pensions' RBL valuation was addressed so that the full value of assessable money transferred into the fund's reserves is captured and assessed [5]**;**
   - the actuarial guidelines were amended to ensure that an adequate income stream was paid.
5. Also, as noted in our original submission to your Review:
   - Where capital remains after beneficiaries have died and is passed on to other members of the fund, it is taxed at up to 15% when allocated to the beneficiaries' superannuation accounts, and is included in the beneficiaries' RBL calculations.
   - Preventing SMSFs from running defined benefit pensions may result in fewer people choosing these pensions for their retirement and, in turn, in faster depletion of retirement capital and more reliance on the aged pension.
6. Furthermore, the estate planning process afforded through SMSFs running defined benefit pensions can in fact **support** government retirement income policy. This is because balances passed onto beneficiaries from the fund's reserves are **fully preserved**; and are included in the beneficiaries' RBL assessable amount.[6] Therefore, death benefits are effectively used to boost retirement funding and reduce the next generation's reliance on government income support, without avoiding the RBL limits imposed on individuals. If the tax deferral issues can be addressed in this way, there is little reason why people can't have their SMSF run a defined benefit pension.

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[5] The concern with the tax deferral and minimisation implications of defined benefit pensions arises because of these pensions':

- perceived effect of transferring wealth to the next generation
- ability, under current rules, to reduce the assessable amount for RBL purposes.

This occurs because the part of the purchase price (for these pensions) not required to fund the expected future pension (as certified by an Actuary) is transferred into the superannuation fund reserves. The part that is required to fund the pension is invested to meet the pension obligations. Upon the recipient's or reversionary's death, pension obligations cease, and the remaining balance is passed onto beneficiaries but **preserved** in superannuation.
Another way to reduce tax deferral through manipulation of the amounts assessable for RBL purposes, would be to make sure that the full value of assessable money transferred into the fund's reserves was captured and assessed for RBL purposes. That is, the Actuaries could (and should) still set aside prudent reserves, but the RBL excess benefits tax would not be deferred or avoided.

[6] There is no scope for the beneficiary to spend these amounts before meeting a condition of release (normally retirement). Another positive factor from a tax perspective is that, when the reserves are allocated to a member who has not met a condition of release, the investment income from this capital is taxable at 15%.

G) Prudential issues

1. Prudential issues are not necessarily a major concern to SMSFs due to the nature of the fund structure and relationships. The risk of SMSF-run defined benefit pensions running out of money:
   - does not appear to be a significant one
   - is voluntarily assumed
   - should be minimised by a good actuary.
2. However, the Government has said that, in limiting funds that can run defined benefit pensions to those with >50 members, it is trying to address prudential concerns about paying a defined benefit pension from an SMSF; although, its advisors have not explained why they are so concerned that small funds might not be able to meet their pension obligations. [7]
3. There are existing actuarial protections – and these safeguards could be boosted. [8]
4. The broader prudential concerns can be largely be addressed by:
   - tightening actuarial guidelines and providing more / better actuarial guidance to fund members & trustees
   - using currently available tax avoidance legislation and 'teeth'
   - better educating SMSF trustees about their obligations.
5. Also, whilst the Government may be concerned about the level of reserving in small funds paying defined benefit pensions, and that there may be inadequate provision or over-provision, other ways (eg, by requiring greater investment diversification or by reviewing the actuarial standards) should be explored to manage this.

[7] There seems some inconsistency in the concern about SMSFs becoming insolvent **combined with** concern about them having 'too much' money left over when the fund member dies and the pension 'reverts' to their beneficiaries. See 'F' – Estate Planning)

[8] Higher actuarial standards were introduced for SMSFs in 1999, thereby reducing the risk of insolvency. This could be strengthened with further guidance to trustees and to actuaries about appropriate valuations. Also:

- The Government could look at the relevant rules & regulations to ensure better protection of reserves and reasonable valuations – so pensions are more secure.
- Prudential concerns about SMSFs running defined benefit pensions are, to an extent, addressed by the requirement that SMSF-run defined benefit pensions **must** obtain an actuarial certificate each year to certify whether there is a high degree of probability that the fund can continue to meet its pension liability. This could be boosted by other safeguards against unwise / unsafe investment practices by trustees of funds paying complying pensions.

H) Other SMSF- related concerns

1. We acknowledge that Treasury and other departmental advisers have certain reservations about the prospect of Choice prompting a 'mushrooming' of SMSFs and their use by those lacking the expertise to efficiently and effectively manage their superannuation assets.
2. We share a concern that some people will opt for SMSFs without the skills and time, or the 'right' advice or assistance, to manage their fund properly. [9]
3. As has been evident in the FPA's participation in forums to improve financial literacy and Super Choice educational material, we place much emphasis on education and disclosure which assists the consumer to make an **informed** choice. We not only understand the risk that, in the post-Choice environment, consumers might be talked into superannuation 'switching' decisions not necessarily in their best interests, but are serious about reducing this prospect. To this end, we not only emphasise the importance of people obtaining **professional advice** in order to make sound decisions about meeting their retirement needs, but we are focusing on our members' professional and professional practice standards.
4. We support that those providing financial services advice are regulated with respect to that advice, particularly where personal financial advice is involved. However, we regret that this regulation is not uniform. As we have submitted to the Government, its decision to provide accountants with 'partial' relief from FSR licensing (commonly called 'accountants' 'carve-out') – so that they can provide advice about the acquisition & disposal of SMSFs – does not sit well with the concern about a mushrooming of SMSFs amongst those who don't understand or can't meet the relevant obligations. Members have told us of anecdotal evidence that some accountants are recommending that clients 'switch' into an SMSF – **even if** the client either does not have adequate funds to make this a realistic option and / or does not fully understand the obligations and workload involved.

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[9] As noted in our original submission to your Review:

A. Some will take the SMSF option without understanding that the term 'self managed' does **not** mean 'requiring no management'.

B. Opting for an SMSF does not mean that a consumer can or should establish and manage the fund without advice; and that advice might be even more crucial if the client likes the idea of an SMSF but doesn't really have the knowledge, time and/or the will to set up and run one without assistance.

C. Financial planners have the knowledge and training to understand all the relevant rules, ensure that all options are considered and to recommend the best strategy for their client.

Also, with respect to the standard of financial planning advice, we note that the FPA is working to:

1. Reinforce members' Professional Standards.
2. Foster compliance with our Code of Ethics.
3. Reinforce our disciplinary program relating to breaches of FPA Rules of Professional Conduct and Code of Ethics.
4. Rid the industry of 'bad apples' (ie, unscrupulous &/or inept advisers)
5. Identify & address potential conflicts of interest surrounding adviser remuneration.

VI. Concluding Comment

i) Address avoidance and prudential concerns without limiting Choice

The FPA:

1. Reconfirms its support for efforts to further limit the use of superannuation arrangements as a vehicle to avoid tax or to abuse asset-test exempt pensions.
2. Reaffirms its belief that the vast majority of existing SMSF members using defined benefit pensions do so for legitimate reasons and follow reasonable (rather than aggressive avoidance) strategies; and should not be disadvantaged in an attempt to 'capture' the small minority who exploit SMSFs.
3. Has suggested alternative ways to achieve the Government's legitimate anti-avoidance and prudential aims, and has offered and will continue to offer its assistance in 'working through' and commenting on alternative options to achieve these ends.
4. Supports Choice and reaffirms that unreasonably 'closing off' the choice to decide **where** to get your retirement income and **what form** it takes does not 'sit' with the Government's stated position.
5. Questions the limitation on Choice; and suggests other ways to address concerns about tax avoidance and prudential strength.
6. Repeats its recommendations that:
   - RBL tables be updated
   - actuarial guidelines be strengthened
   - more emphasis be placed on educating SMSF fund members & trustees.
7. Confirms its belief that there is unwarranted concern about the tax deferral potential of SMSFs offering defined benefit pensions, and that the estate planning benefits of these pensions can actually reinforce Government strategies to constrain future demand for income support.

ii) Review's outcomes must be well-considered

We welcome the Review.

Whilst we see the Discussion Paper as a useful first step, we are aware that there is relatively little time remaining before your Report is expected by the Government.

We therefore take this opportunity to reaffirm our belief that there should be no further fundamental changes to the Superannuation regime (except restoration of the ability of SMSFs to run defined benefit pensions) until all the issues and options (and their respective pros & cons) have been thought through in consultation with stakeholders including the industry associations of practitioners such as financial planners. Also, related reform should be:

I. Delivered in a consistent package or in discernible and logical stages.
II. Clear in its purpose and delivery, including in transitional arrangements.
III. Well-communicated to those on whom it impacts.

iii) The 'bigger picture' and longer-term perspective

Our original submission to Treasury's Review:

1. Noted that retirement & superannuation policy (itself complex) does not stand in isolation from other types of policy (eg, Tax policy and Social Security policy).
2. Suggested that a whole-of-government approach would maximise the prospects of meeting agreed ends for **each** of the related areas and objectives; and that government should have a longer-term perspective.
3. Suggested that, with respect to the intersection between retirement incomes policy, taxation policy and income support policy, considerations such as the following should feed into the relevant decision-making:
   - Australians' future financial stability and their willingness to invest in their post-retirement future
   - public perception of the superannuation system and its stability
   - the maintenance of genuine Choice of fund and income stream, and Australians' ability to choose a superannuation option suiting their circumstances
   - that the estate planning features of SMSF-run defined benefit pensions 'preserve' funds in the superannuation system and this constrains future income support spending
   - the public perception that, in framing relevant policy, the Australian polity is not driven solely by short-to-medium-term concerns about **potential** (if unquantified) revenue leakage.

In conducting and reporting on your Review, please remember that the Government – to whom you are reporting – will need to view 'the bigger picture'.

Also, when estimating the respective cost of the various options raised in the Discussion Paper, the longer-term costs and benefits of various options should be factored in; and the cost benefit analysis should not be restricted to revenue leakage and the short-term.

iv) Consultation is essential

1. As noted above, superannuation policy is a complex area, but the industry has offered its assistance to government to work through the issues.
2. The FPA is the peak organisation representing professionals who provide financial planning advice to households. We are therefore well-placed to assist the Government and policy-makers to understand superannuation reform options and their respective 'pros & cons', particularly each option's likely impact on households.
3. We offer to act as a 'sounding board' and to assist in developing retirement / superannuation-related policy proposals and alternative options which meet the Government's legitimate objectives but without compromising Choice.
4. We guarantee to keep these discussions confidential, especially where revenue concerns are involved.

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