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Manager
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Dear Sir/Madam

Reducing administrative complexity for legacy pensions in self-managed superannuation funds ("SMSFs")

The Actuaries Institute is writing to Treasury to raise several legislative and regulatory issues with legacy pensions (defined below). The recent Superannuation Reforms have added further complexity and restrictions on these legacy income streams causing significant difficulties for many of the relatively few remaining SMSF pensioners with these pensions.

The Actuaries Institute recommends that Treasury consider reforms to tackle these issues such as allowing affected pensioners to restructure their retirement savings into simpler, modern income streams.

Background

Legacy pensions referred to in this submission include those defined under the Superannuation Industry Supervision Regulations 1994 provisions as follows;

- 1.06(2) – lifetime defined benefit pensions
- 1.06(6) – defined benefit flexi-pensions
- 1.06(7) – life expectancy defined benefit pensions
- 1.06(8) – market-linked pensions

The first three of these income streams are "defined benefit" in nature – a pension amount is promised under specified terms and conditions rather than the annual payment being linked to the account balance available to support the pension.

Three of these income streams (1.06(2), 1.06(7) and 1.06(8)) are also referred to as "complying" pensions which are income streams that have historically provided beneficial tax and/or social security treatment. In return, pensioners were very restricted in the amounts they could draw from these pensions and the changes they could make to them. While some of the social security benefits remain today, the special tax treatment has been largely irrelevant since 2007.

It has not been possible to start new defined benefit pensions in an SMSF since 1 January 2006 and new market-linked pensions since 20 September 2007. The legislative and regulatory environment has moved on significantly in the subsequent years.

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The major superannuation simplifications of 2007 largely ignored these pensions and therefore missed a key opportunity to address their special complexities. More recent changes in 2017 to introduce the transfer balance cap required complex and cumbersome exceptions to deal with the legacy products (some of the associated issues are yet to be resolved). In other words, something that was already complex became even more complex.

The pensions are particularly problematic for SMSFs because:

- They are rare, meaning neither the industry nor the regulator has invested significant time in resolving some practical challenges they present when (say) the recipient dies or wishes to wind up their SMSF as they age
- They are by definition paid to our oldest superannuants. In an SMSF, the youngest recipient would be 70 today with most being 80 or older. This is exactly the demographic often looking to wind up their SMSF and encountering barriers due to these pensions[1]
- Given the ages of the recipients, the balances involved are also reducing. Again, this would often result in the SMSF being wound up if not for these pensions[1].

As the recipients age, we expect the ATO to be increasingly asked to provide guidance via private or public rulings. Given the relatively few funds affected, this will require the regulator to devote a disproportionate level of resources to issues that affect very few people. In our view, the Government has a unique opportunity to avoid this waste with minimal impact on revenue by simplifying the legislation surrounding these pensions now.

The key issues are discussed in more detail below.

Issues arising

Trapped reserves from defined benefit pensions

Many of the recipients of these legacy pensions are now advanced in years and the pensions are ceasing as a result of the beneficiaries passing away or the term coming to an end. With the liability to make further benefit payments ceasing, any remaining capital after a defined benefit pension ceases is left in a reserve in the fund.

These leftover reserves present a range of administrative issues for SMSFs. The ATO's application of the current tax regulations means that it is not possible to pay out these reserves without first allocating to a member interest. These allocations can incur highly penal tax charges, unless allocated within certain limits, which can take many years.

Following the death of the defined benefit pensioner there may be no remaining members in the fund. Dealing with remaining reserves in these circumstances is extremely complex. Even where it is possible under an SMSF's trust deed to allocate the reserve to a deceased member's interest in the fund in order to allow a superannuation death benefit payment, the tax consequences of doing so are severe. It is not uncommon for half of the capital paid to beneficiaries of the deceased to be lost to tax charges. For large reserves the penalties can be even higher. The practical implication of these punitive tax rates is that trustees may structure their affairs in such a way as to avoid this outcome. For example, the remaining capital can be retained in the superannuation system as a reserve with new beneficiaries joining the SMSF to take advantage of them in the future.

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[1] With the exception of flexi-pensions, these products are non-commutable and can only be commuted if the proceeds are used to commence a new complying income stream. Even for flexi-pensions commutation is often problematic because of the issues associated with remaining reserves (as discussed later).

While flexi-pensions can be commuted they are also often impacted by the restrictions on the amount that can be commuted. Where the capital backing these types of pensions exceeds the maximum commutation amount prescribed by superannuation law, balances can similarly become trapped in reserves.

The Actuaries Institute has recommended a number of times that that the maximum commutation factors in SIS Regulation 1.08 be abolished. This regulation is a hangover from the pre-2007 Reasonable Benefit Limit regime and specifies anachronistic maximum commutation factors determined in the quite different economic circumstances of the early 1990s. As a result, corporate funds have regularly applied to APRA for approval of higher factors which take into account current economic conditions and expected mortality rates. Fund specific factors for SMSFs are impractical for the regulator to administer.

Surplus assets

Where an SMSF's investment performance has exceeded initial predictions, funds may have built up levels of assets supporting defined benefit pensions that significantly exceed those needed to meet the liabilities. For large employer sponsored defined benefit funds this outperformance often would result in a benefit to the employer in terms of reduced future contributions or refund of surplus.

Under the current rules for SMSFs there are very limited options for trustees to reduce the level of surplus assets. While the trustee has invested the assets to the benefit of the member, there are no provisions for the trustee to pass on this benefit in terms of benefit payments to members. Solvency standards for defined benefit pensions mean SMSFs are required to hold surplus assets above the value of their liabilities, but have limited options to manage these when they get too large. Surplus reserves often result in the situations described above when pension liabilities expire.

Transfer balance cap valuations

The provisions for valuing these pensions against the transfer balance cap are complex and can result in perverse outcomes. Some of these are aiming to be addressed in the Treasury Laws Amendment (2019 Measure No.3) Bill 2019 (see the Actuaries Institute's submission dated 3 April 2019 for our comments on these). However, many of these issues will persist.

For example, members wishing to restructure existing complying pensions can only do so by commuting the pension and recommencing a new complying pension with the whole of the proceeds. However, new complying pensions started after 1 July 2017 are not classed as Capped Defined Benefit Income Streams. As such, where their purchase price exceeds the transfer balance cap an excess transfer balance will be raised. However, because these income streams are non-commutable, the member has no ability to rectify the excess and may be penalised for the ongoing excess.

The net result

We estimate only a few thousand of these pensions remain in place in SMSFs. Their complexity makes them difficult to run for both trustees and their advisers. There are strong arguments for action here with the aim of reducing red tape by dealing with that unnecessary complexity. The problems are compounded by the fact that the recipients of these pensions are in their 70s, 80s or older.

We are aware of some of the previous arguments to avoid making any changes here but feel they are not necessarily supported by the facts. For example:

- Some would argue that this is largely a problem for the wealthy who took advantage of particular tax or social security benefits at the time. However, this doesn't reflect the current reality for many; the median balance supporting a defined benefit pension in an SMSF is less than $200,000[2]. As balances are depleted many of these SMSFs have or will become uneconomic, but trustees have limited options to restructure into products with lower fees.
- Some would argue that these arrangements were entered into willingly by the pensioners at the time and hence there is no driver for change now. However, the two major rounds of superannuation reforms that have occurred since that time have changed the rules considerably. Not only did this group miss out on the (beneficial) simplification afforded to all other superannuation members in 2007, but the changes then and in 2017 have made their position worse. To pick one example, when a complying lifetime pension was established in 2005, the death of the pensioner could result in a large reserve being created the SMSF. At the time, however, the reserve could be paid out as a death benefit or allocated to another member with vastly fewer problematic consequences than today. In other words, the rules and how they are applied have been changed considerably since these pensions were established.

Solving the problems

Solutions to the above issues are likely to require legislative changes and care will need to be taken not to impact the operations of larger defined benefit funds. We suggest that any changes are limited to legacy pensions held in SMSFs.

One solution to the myriad problems faced by holders of these legacy pensions would be to amend the regulations to allow them to be commuted. This could be compulsorily to remove these pensions from SMSFs altogether, via a time limited amnesty or by introducing ongoing flexibility to commute. Each option has its benefits and drawbacks and they are likely to have differing levels of efficacy in removing these pensions from SMSFs.

To avoid the issue of capital being left in reserves following commutations, the current restrictions on commutation values would also need to be considered. Allowing the commutation value for an SMSF defined benefit pension to equal the balance of the reserve or capital backing the pension without restriction would allow SMSFs with these pensions to remove their reserves entirely. This would be in line with the ATO's guidance which indicates a clear preference for SMSFs to remove reserves as soon as practicable.

Consideration of the impact on assets test-exempt (ATE) pensions would also be needed. Options already exist for legacy pension holders to transfer to alternative products and retain their ATE status. However, where an ATE pension is commuted, current Social Security rules can require a re-assessment of the last five years Age Pension entitlements assuming that the assets were never entitled to the exemption. Changes to these rules may be required to ensure that members are not penalised with Centrelink debt demands as a result of commuting their legacy pensions.

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[2] Analysis based on data from Accurium Pty Ltd.

A less ambitious reform would be to focus on tackling the issues that arise when these types of pensions cease, leaving the rules for pensions still in payment unchanged. Requiring any remaining capital supporting a defined benefit pension when it ceases to be paid out of superannuation, for example as a death benefit for a lifetime pension, would remove the issues with trapped reserves. This option has the added benefit of reducing the opportunity for estate planning strategies whereby capital is retained in the tax concessional superannuation environment as reserves.

Many legacy pensions have already ceased, leaving behind significant reserves in the SMSF. These represent an ongoing tax and compliance problem for trustees and the ATO. Treasury should consider how to tackle these ongoing issues in any proposed solution.

The Actuaries Institute would welcome the opportunity to discuss this submission and any potential solutions. Please do not hesitate to contact the CEO, Elayne Grace elayne.grace@actuaries.asn.au , to discuss any aspect of this letter.

Yours sincerely

Hoa Bui
President