



PITCHER PARTNERS

Department of Treasury

Review of Defined Benefit Pensions

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TABLE OF CONTENTS

1. Background	4
2. Pitcher Partners' Perspective	4
3. Matters Absent from Treasury's Discussion Paper	5
3.1 Hard evidence	5
3.2 What SMSF Members Want	5
4. Effect of Defined Benefit Pension Regulatory Amendments.	7
4.1 Available Options	7
4.2 Uncertainty	8
4.3 Retrospective Amendment	8
4.4 Inequity	8
4.5 Devaluing SMSF Asset Values	9
5. Cause of the Perceived Problems	9
5.1 Legal Pensions	10
5.2 Excess benefits tax	10
5.3 Government Inactivity	11
6. Analysis of perceived problems	11
6.1 Compression	11
6.2 Estate Planning	12
7. Conclusion	12
7.1 Guarantee of pension not appropriate for SMSF	12
7.2 "No residual capital value" not appropriate for SMSF	13
8. Viable Alternatives	13
9. Proposed New Model	14
9.1 Common Requirements	14

Department of Treasury

9.2 Regularly Assessed Lifetime Pension	14
9.3 Enhanced Market Linked Pension	15
10. Pension Valuation Factors	15
10.1 Cost to Government	15
10.2 Clients perception	15

The following submission is in response to the discussion paper issued by Treasury in January 2005 entitled “Review of the Provision of Pensions in Small Superannuation Funds”.

1. BACKGROUND

Pitcher Partners is an association of independent chartered accounting firms located in Melbourne, Sydney, Brisbane and Perth. This submission emanates from the Melbourne firm.

The Melbourne firm of Pitcher Partners has a specialist superannuation group offering accounting, audit and consulting services to its clients, including client Self-Managed Superannuation Funds (SMSF). The practice has in excess of five hundred SMSF clients. Of these funds, approximately one hundred are currently paying pensions.

Of the pension funds, nine funds are paying lifetime pensions of which four are complying lifetime pensions and five are non-complying lifetime pensions. Three of the four complying pension funds became clients of Pitcher Partners after they had commenced paying complying pensions.

2. PITCHER PARTNERS’ PERSPECTIVE

With respect to the perceived concerns raised in Treasury’s discussion paper, we consider that there are two distinct groups affected.

One group is superannuants with comparatively low account balances who are, in Treasury’s view, availing themselves of lifetime pensions in order to also access Government funded age pension benefits.

The second group are those with substantially more assets in superannuation who increasingly have superannuation balances in excess of their relevant Reasonable Benefit Limits (RBL) and, in Treasury’s view, are availing themselves of an opportunity to have their benefits measured within their relevant RBL.

This practice has no clients in the former group. Our comments relate entirely to clients that have more substantial superannuation account balances, and increasingly, account balances in excess of their RBLs.

3. MATTERS ABSENT FROM TREASURY'S DISCUSSION PAPER

3.1 Hard evidence

Since the introduction of Regulations on 12 May 2004 intended to stop SMSF paying defined benefit pensions, we have followed the course of the discussion and submissions (both written and verbal) to the Senate Economics Legislation Committee.

We note that neither Treasury, nor the ATO in their submissions to the Senate Select Committee or in the discussion paper addressed here, have provided any hard evidence as to the quantity, dollar value or cost to revenue of the perceived problems that were intended to be addressed by the Regulations. The concerns raised in the discussion paper do occur in the market place, but in our experience at least, they are comparatively rare.

3.2 What SMSF Members Want

The other significant matter that appears to be missing from Treasury's discussion paper is a discussion of what SMSF members actually want from their SMSF and what they actually want to achieve with the monies that they have saved for retirement. The discussion paper addresses Government desires, Treasury desires, the ATO's desires but at no time addresses what the SMSF member wants.

Assisting our clients with retirement and estate planning is a significant part of the superannuation services provided by this practice. In our experience our SMSF member clients have the following objectives for their accumulated superannuation:

- Control
- Tax efficiency
- Pension for the whole of their lives
- Control over remaining assets on death
- Simple, understandable and cost efficient operations
- Predictable pension amount

3.2.1 Control

Primarily, SMSF members want control of their superannuation monies during their retirement and, in addition, some control over what occurs to any remaining monies upon their death. This desire for control is a common characteristic of people who commence a SMSF. Where a client is not interested in taking the responsibility that goes with control of a SMSF, we advise them against commencing such a Fund.

In our experience members do not want this control to “get away with” things that they could not do in other superannuation vehicles. They want control so that they can understand what is happening in their fund, and by their own efforts enhance the value of their retirement assets. There is no guarantee they will achieve such an outcome but in our experience this is the member’s primary intention. We note that purchasing a lifetime pension from a Life Office (as allowed for in the amended SIS Regulations) is diametrically opposed to the mindset of the SMSF member and is consistently dismissed out of hand. In our experience we have never seen a SMSF or SMSF member purchase a lifetime pension.

3.2.2 Tax efficiency

Members want their pension arrangements to be as tax efficient as possible. However, we consistently see superannuants who will forsake tax efficiency for flexibility and control. Tax is a significant, but not a major driver, in deciding the style of pension that the member should receive.

3.2.3 Pension for the whole of their lives

Members want to live off their accumulated retirement funds for the whole of their life. We have never seen a client who willingly runs down the assets in their fund rapidly without concern for the longer term. Indeed given these fund members have worked very hard during their working life to accumulate the wealth in their fund, they are determined it will be used to provide them with a quality retirement for the long term.

3.2.4 Control over remaining assets on death

SMSF members want to be sure that any assets remaining upon their death go to their Estate or their dependents. In practice, most often the first question a SMSF member asks when addressing retirement planning is “what will happen to the remaining assets when I die?” Our clients are consistently reluctant to use a style of pension in their SMSF that creates difficulty in passing on assets to their dependents upon their death. We

have repeatedly seen clients with significant fund assets, even with significant excess benefits, choosing to take a non-defined benefit pension purely because of the difficulty that the “no residual capital value” rule brings to dealing with remaining assets in a SMSF.

It is our experience that the so called “Estate Planning” concern expressed by Treasury (whereby the member seeks to retain as many assets as possible within the fund to pass on to the next generation), is more often a consequence of the complying pension rules rather than an attractive feature when members choose the style of pension they wish to draw.

3.2.5 Simple, understandable and cost efficient operations

Members want their style of pension to be simple, understandable and cost effective to run. Many SMSF members decline to consider Defined Benefit pensions simply because that style of pension is difficult to understand and costly to run both in terms of actuarial fees and accounting/audit fees.

3.2.6 Predictable pension amount

The one aspect of a complying lifetime pension that SMSF members find attractive is the consistent smoothed pension payments this style of pension produces. Allocated and Market Linked pensions often produce uneven pension flows based on underlying asset values year by year.

Our overall conclusion is that SMSF members want to achieve much the same outcomes as the Government. They want to accumulate sufficient assets to be able to live comfortably in retirement from those assets. Fund members rarely approach retirement planning with the intention of squeezing every last dollar of tax concession that they can out of the Government.

4. EFFECT OF DEFINED BENEFIT PENSION REGULATORY AMENDMENTS

4.1 Available Options

The first and major outcome of the regulatory amendments is that in practice SMSFs only have one viable pension option that allows the fund members to access their pension RBLs. As addressed in 3.2.1 above, the concept of a SMSF member using the fund assets to purchase a lifetime pension from a commercial provider is diametrically opposed to the mindset of a SMSF member. In our opinion, SMSF members will virtually never be

able to use this option. As a result, in practice the Market Linked pension is the only pension that allows SMSF members to access their pension RBL.

4.2 Uncertainty

The amendments have created significant uncertainty in the minds of SMSF members who are planning retirement in the near future. The amending regulations became law the day after they were announced in press releases with the budget papers, with no industry consultation. The regulations were strongly attacked by the superannuation industry, the press and by the Senate Select Committee, leading to the current review.

Throughout this period, Fund members have been left wondering what options are actually available to them and what options may become available. It appears likely the final answers to these questions will take in excess of twelve months. On behalf of our clients we find this unacceptable. We have a number of clients who have had to put their planning “on hold” pending the resolution of this review. This cannot be in their or the Government’s interests.

4.3 Retrospective Amendment

These amendments are, in our view, effectively retrospective in the way they affect SMSF members. The ATO’s interpretation of “governing rules” is that the fine detail of the lifetime pension arrangement must already be written into the constituent documents of the fund prior to 12 May 2004. If we accept this view, in our opinion no SMSF will ever have appropriate governing rules before 12 May 2004. SMSF members will, in practice, never be able to avail themselves of this grandfathering, so the regulations are effectively retrospective.

4.4 Inequity

One of the clear perceptions coming out of these amendments is there is now one set of rules for SMSF members, a more favourable set of rules for members of larger regulated funds and a yet better still set of rules for government employees.

We believe it is incumbent on Government to design laws that treat superannuants in similar circumstances (i.e. retiring and drawing a pension) equally regardless of the superannuation vehicle that is to pay the benefit. This perception is particularly damaging when the people who are perceived to receive the most favourable treatment are those responsible for designing and implementing the laws.

4.5 Devaluing SMSF Asset Values

Under the Regulations a SMSF can only pay a defined benefit pension if the fund purchases a matching pension from a commercial provider.

This requirement effectively devalues the fund assets. Commercial defined benefit pension providers are very conservative and base the underlying earnings of the pension assets on long term fixed interest investments. This represents a generally poor and unattractive investment for a SMSF. Their assets are worth less to them invested in a commercial defined benefit pension than invested otherwise within the fund.

By way of example, a 65 year old CSS member has \$100,000 in member and productivity components with which they can purchase an \$11,000 non-indexed complying pension. If they rolled this \$100,000 over to a SMSF and used it to purchase a matching complying lifetime pension from a commercial provider, they would receive a pension of \$7,184. They have lost 35% of the value of their entitlement in the SMSF. This is the fate SMSF members have had handed to them by these Regulations.

In addition SMSF members will have to bear Capital Gains Tax on profits realised in the fund on selling up fund assets in order to purchase a commercially provided complying pension.

5. CAUSE OF THE PERCEIVED PROBLEMS

Treasury has identified three issues they perceive as problems caused by allowing SMSFs to pay defined benefit pensions, being:

- Compression - by which some SMSF members can achieve an RBL value for their pension that is less than the value of the assets held to pay the pension.
- Estate Planning – by which some SMSF members seek to pass fund assets on to the next generation rather than the assets being paid out to the SMSF pensioner.
- Social Security – by which SMSF members take defined benefit pensions in order to qualify for social security benefits that would not be available with another style of pension.

We will address the first two of these concerns that, for simplicity, will refer to as “perceived problems” under section 6 below. First, however, we wish to make the following comments about the underlying causes of these perceived problems.

5.1 Legal Pensions

The first thing to acknowledge is that fund members who engage in any of these practices are doing nothing illegal.

Their pensions comply with every legal requirement placed upon them without any contention as to the meaning of the words in the legislation. We are concerned the debate to date has sought to “demonise” the fund member who has constructed an entirely legal pension. In doing so, the debate has avoided addressing what, in our opinion, is the real cause of the perceived concerns.

In our opinion there are two real underlying causes:

- Excess Benefits tax
- Government inactivity

5.2 Excess benefits tax

For many people in the community and particularly those in our client base, the current RBLs are forcing a significant portion of the member’s entitlements into excess benefits. We acknowledge the Government’s right to set the RBLs at whatever level they deem appropriate and to limit the tax concessions that are made available to superannuation members. However, in our opinion the level of RBLs and the penalty for exceeding RBLs are major contributing factors to both perceived problems.

No fund member ever deliberately sets out to exceed their RBL. Most often members exceed their RBL because of the investment performance of the fund assets. This is particularly the case in a SMSF where members are able to be much more specific in selecting fund assets. When these assets perform, the member benefits accordingly. One example from our client base is as follows:

- Husband and wife in their mid fifties. They both had entitlements of \$400,000 in their self-managed Superannuation Fund. They decided to buy premises from which to run their business (they each ran a separate business). The fund was able, at this time, to avail itself of investing in a controlled unit trust. The fund invested the majority of its assets in the unit trust and the unit trust borrowed \$300,000 (25 – 30% gearing), bought a \$1,000,000 property and spent \$100,000 on renovations. The businesses occupied the premises and paid commercial rent for the next five years. By that time, the borrowing in the Trust was substantially reduced and the Trustee

received an unsolicited offer to sell the building for \$3.2 million. The Trustee accepted the offer, sold the premises and the two members retired. Both members then had significant excess benefits, which they did not set out to achieve, but had achieved through the outstanding performance of the fund's investment.

This is not a unique outcome among our clients although the timeframe over which the gain was achieved may well be shorter than in most cases.

The principal concern of our clients in respect of RBLs is the penalty for exceeding their RBL. In their mind the penalty is extremely punitive when they have done nothing other than make good investment choices and achieve a good investment outcome. The inequity of these penalties is a major motivator for members to find a way by which they will not have an excess benefit.

5.3 Government Inactivity

The second cause for the current perceived concerns is the Government and its instrumentalities unwillingness to address and update the current Pension Valuation Factors (PVFs) included in the SIS Regulations. These factors were last updated in June 1994. We contend that if the PVFs had been updated, such that the valuation of a lifetime pension reasonably approximated the assets being held to pay that pension, none of the perceived concerns would have occurred.

The combination of these two causes provided an opportunity for the use of lifetime pensions to overcome excess benefits.

6. ANALYSIS OF PERCEIVED PROBLEMS

6.1 Compression

The so-called "compression" issue is driven substantially by the PVFs that, as we said earlier, Government has overlooked updating for some time. However, the problem is made worse by the requirement in Regulation 1.06(2) of the SIS Regulations that the trustee in effect "guarantee" that the pension will be paid for the life of the pensioner. This is clearly a problem for a SMSF, where the member has an unknown lifespan but the fund has a known and finite amount of money available to meet the pension.

An actuary will naturally be very conservative about the amount of pension they are willing to approve when designing a lifetime pension in a SMSF, for fear that this guarantee may not be achieved. This leads to a comparatively low first year pension, which in turn, leads to a comparatively low RBL value.

In our opinion the compression achieved is an outcome of the out of date valuation factors and the requirement that the pension effectively be guaranteed for life.

6.2 Estate Planning

Another outcome of the actuary being conservative is that there is a high probability there will be assets, perhaps substantial assets, remaining in the fund upon the death of the member or reversionary (the “estate planning” concern).

Another of the complying lifetime pension rules in Regulation 1.06 is that a lifetime pension may have no residual capital value. Upon the death of the pensioner and their reversionary, the remaining assets in the fund belong to the trustee and are not assets that a dependant of the member has a right to claim. This leads to the obvious question, “What happens to assets left in a SMSF in these circumstances?”

Various planners have devised answers which mainly revolve around “passing the fund” onto other family members who in time draw superannuation benefits from the remaining assets. Our clients view this outcome as most unsatisfactory. It is an outcome that people will only accept because the alternative (paying excess benefits tax) is so unpalatable.

7. CONCLUSION

7.1 Guarantee of pension not appropriate for SMSF

We draw a number of conclusions from the above. In the context of this discussion paper, it is clear to us that a complying lifetime pension, as currently defined in SIS, is simply not appropriate for a SMSF. The concept of a trustee giving a guarantee of the pension to the member (when the trustee and the member are the same person) is absolute nonsense. In practice, members with a lifetime pension in a SMSF know that if the assets run out, their pension will stop. There is no third party who will come in and satisfy the guarantee.

As a small aside, we understand very few Life Insurance Companies in Australia offer Lifetime pensions. We understand that they too dislike providing a “guarantee” of the pension. The Life Offices want to have underlying investments that have a term that matches the term of the pension commitment being given. That way they know what to expect from the investment and can reduce the risk in making their pension commitment.

The longest-term investment available in Australia is a 10-year bond. If the Life Office has to guarantee the pension for an expected 25 years, there are two points where they have to re-invest the underlying investment (at 10 and 20 years), which exposes them to investment risk in meeting their guarantee. We understand the UK Life Offices have similar problems.

Interestingly, it may not be long before SMSFs are the only type of fund where the trustee is willing to take the investment risk underlying a lifetime pension (as they do now).

7.2 “No residual capital value” not appropriate for SMSF

The requirement that there be no residual capital value drives members, who, for other reasons want to accept a lifetime pension, into far more complicated, convoluted and, in Treasury’s view, unacceptable planning techniques than they would otherwise want. We believe almost all members would be happy for any remaining assets to be passed onto their family with some tax burden that recognises that it is an excess benefit, so long as the burden is not punitive.

As such, we consider the current model of a complying lifetime pension does not fit with SMSFs.

8. VIABLE ALTERNATIVES

Under the present rules, there is only one alternative available to SMSF members if they want to access their pension RBL, the recently available market linked pension (MLP). Our experience, in the brief time that these pensions have been available, is that prospective pensioners have reacted quite positively to them and a number have begun to use MLPs in their retirement.

While these are still early days, a number of pensioners who have started MLPs have commented that the pension amount paid out of the fund is greater than either their needs or greater than they are comfortable with. They would prefer a somewhat slower flow of pension from the fund. A number have commented that they intend to “save” from their pension by putting aside some of the pension each year. They fear they will outlive the term of the pension and would need to have built up another pool of money in order to finance the latter parts of their retirement. This seems to be a non-sensical outcome from this style of pension.

We understand, from consultant actuaries that we deal with, that they expect the majority of our client base to outlive, probably significantly, their life expectancy from the current life expectancy tables. We understand these tables are the average of the life expectancy of all Australians at various ages. However, the actuaries contention is that our client base, by and large, have

lived a better lifestyle, are in better health than average Australians and statistically are very likely to outlive their life expectancy. This is a view that we convey to our clients as part of any retirement and estate planning that we undertake with them.

In our view, the appropriate outcome from this current review should be that a greater range of pension styles are made available to SMSF members so that they have the ability to choose a pension style that suits their life style, life expectancy and comfort levels within a range of parameters that the Government is comfortable with.

9. PROPOSED NEW MODEL

9.1 Common Requirements

In our view, there should be a number of new models of pensions that allow members to access their pension RBL. These pensions should have a number of common requirements with the variable factor being the pace at which fund assets are paid from the fund. The common requirements would be as follows:

- they not be required to “guarantee” the pension for the pensioners’ lifetime.
- the pension be non commutable during the lifetime of the pensioner or any named reversionary.
- the pension be allowed to have a residual capital value that could be paid (or may be required to be paid) to the dependents and/or estate of the member or reversionary on death.
- the RBL value of the pension be equal to the purchase price of the pension i.e. the RBL value equals the value of underlying assets being put aside to fund the pension (excluding undeducted contributions).

9.2 Regularly Assessed Lifetime Pension

We do not have detailed recommendations about how the rate of pension amount could be determined. However, a pension that provides for smoothing of pension payments over a period of perhaps three to five years would appear to be appropriate. The pension amount could then be reassessed for the next three to five years. This would allow for more regular and predictable pension payments regardless of the year-by-year ups and downs of the fund’s performance.

An actuary could carry out a regular lifetime pension calculation taking into account the fund assets and pensioner life expectancy each time, without having regard for a “guarantee”. Actuaries could be issued with tighter parameters applicable to these guidelines to allay any “estate planning” concerns.

9.3 Enhanced Market Linked Pension

As we mentioned earlier, the new Market Linked pensions are proving to be popular with our clients. However, this pension style has a longevity risk for the member. An option would be for the member’s life expectancy to be re-assessed whenever updated Life Tables are issued and the remaining term of the Market Linked Pension adjusted accordingly. We see this as a discretionary option for pensioners on the issue of updated Life Tables. This would provide a simple but effective method for dealing with longevity within already accepted boundaries.

10. PENSION VALUATION FACTORS

While the pension valuation factors provide compression opportunities to SMSF fund members, they also provide compression opportunities to members of every other superannuation fund. While this is not the specific subject of this review, for fairness purposes it needs to be addressed. We are concerned that this will not occur for at least two reasons:

10.1 Cost to Government

If the pension valuation factors were brought up to date, Government provided pensions would become less attractive to some pensioners (because they would more often include a excessive portion). This is most likely to lead to these pensioners requesting either a higher level of pension so that their net after tax pension is unchanged, or to be compensated in some other way for the reduction in value of their pension. In either case the cost to Government, both State and Federal, would be increased. We have no capacity to determine the extent of the likely impact.

10.2 Clients perception

There is a clear and consistent perception within our client base, that one of the reasons that the pension valuation factors have not been changed is that the people with the capacity to change them (Government and its instrumentalities, such as Treasury) are the very people who will be adversely affected by any such change. We make no comment on whether

Department of Treasury

this perception is accurate but raise it with you because it is a strong and consistent perception of our clients.

We hope the above is of some assistance to you in your considerations. We would welcome the opportunity discuss any of the matters we have raised, or to provide further information to the extent that we can. If you wish to pursue any of these options, please contact David Foulds on 03 9289 9838.