COMMONWEALTH OF AUSTRALIA

Proof Committee Hansard

SENATE

ECONOMICS LEGISLATION COMMITTEE

Reference: Superannuation Industry (Supervision) Amendment Regulations 2004 (No. 2)

MONDAY, 9 AUGUST 2004

CANBERRA

CORRECTIONS TO PROOF ISSUE

This is a **PROOF ISSUE**. Suggested corrections for the Bound Volumes should be lodged **in writing** with the Committee Secretary (Facsimile (02) 6277 <FIELD>), **as soon as possible but no later than:**

Monday, 9 August 2004

BY AUTHORITY OF THE SENATE

[PROOF COPY]

INTERNET

The Proof and Official Hansard transcripts of Senate committee hearings, some House of Representatives committee hearings and some joint committee hearings are available on the Internet. Some House of Representatives committees and some joint committees make available only Official Hansard transcripts.

The Internet address is: **http://www.aph.gov.au/hansard**

To search the parliamentary database, go to:
http://parlinfoweb.aph.gov.au

SENATE

ECONOMICS LEGISLATION COMMITTEE

Monday, 9 August 2004

Members: Senator Brandis *(Chair)* Senator Stephens *(Deputy Chair)*, Senators Chapman, Murray, Watson and Webber

Participating members: Senators Abetz, Boswell, Brown, Buckland, George Campbell, Carr, Cherry, Conroy, Cook, Coonan, Eggleston, Chris Evans, Faulkner, Ferguson, Ferris, Fifield, Forshaw, Harradine, Harris, Kirk, Knowles, Lees, Lightfoot, Ludwig, Lundy, Mackay, Marshall, Mason, McGauran, Murphy, O'Brien, Payne, Ridgeway, Sherry, Stott Despoja, Tchen, Tierney and Wong

Senators in attendance: Senators Brandis, Chapman, Sherry, Stephens and Watson

Terms of reference for the inquiry:

Superannuation Industry (Supervision) Amendment Regulations 2004 (No. 2) [Statutory Rules 2004 No. 84]

WITNESSES

BURT, Mr Michael Donald, Actuary, Australian Government Actuary 2

COLES, Mr Tony, Manager, Superannuation, Retirement and Savings Division, Department of the Treasury 2

DOLAN, Mr Alex, Assistant Secretary, Seniors and Means Test Branch, Department of Family and Community Services........ 2

HANSCOMBE, Mr Mathew, Director, Government Initiatives, Australian Taxation Office 2

LEJINS, Ms Erica Noble, Senior Adviser, Superannuation, Retirement and Savings Division, Department of the Treasury 2

MARTIN, Mr Peter Colin, Australian Government Actuary 2

NICHOLSON, Ms Tracey, Assistant Commissioner, Superannuation, Australian Taxation Office........ 2

THOMAS, Mr Trevor John, General Manager, Superannuation, Retirement and Savings Division, Department of the Treasury 2

Committee met at 3.35 p.m.

ACTING CHAIR (Senator Watson)—In the absence of the chair, Senator Brandis, I have been asked to chair this meeting. We are here today to continue taking evidence on the Superannuation Industry (Supervision) Amendment Regulations 2004 (No. 2), as contained in Statutory Rules 2004 No. 84 and made under the Superannuation Industry (Supervision) Act 1993. This is the second hearing held on this matter by the committee.

On 16 June the Senate referred the regulations to the Senate Economics Legislation Committee for inquiry and report, with particular reference to the extent to which defined benefit arrangements have been used for the purposes of tax minimisation, estate planning and reasonable benefit limit avoidance and for any purpose other than providing retirement income; the extent of past losses to revenue from the above measures; and the estimated future losses to revenue likely in the absence of these regulations.

Before we begin taking evidence, I reinforce for the record that all witnesses appearing before the committee are protected by parliamentary privilege with respect to their evidence. Parliamentary privilege refers to the special rights and immunities necessary for the discharge of the parliamentary functions without obstruction or fear of prosecution. Any act by any person which operates to the disadvantage of a witness on account of evidence given by that witness before the committee is treated as a breach of privilege. These privileges are intended to protect witnesses. I must also remind witnesses, however, that giving false or misleading evidence to the committee may constitute a contempt of the Senate. The committee prefers that all evidence be given in public, but should you at any stage wish to present your evidence in private you may do so and the committee will consider your request.

[3.37 p.m.]

BURT, Mr Michael Donald, Actuary, Australian Government Actuary

MARTIN, Mr Peter Colin, Australian Government Actuary

HANSCOMBE, Mr Mathew, Director, Government Initiatives, Australian Taxation Office

NICHOLSON, Ms Tracey, Assistant Commissioner, Superannuation, Australian Taxation Office

DOLAN, Mr Alex, Assistant Secretary, Seniors and Means Test Branch, Department of Family and Community Services

COLES, Mr Tony, Manager, Superannuation, Retirement and Savings Division, Department of the Treasury

LEJINS, Ms Erica Noble, Senior Adviser, Superannuation, Retirement and Savings Division, Department of the Treasury

THOMAS, Mr Trevor John, General Manager, Superannuation, Retirement and Savings Division, Department of the Treasury

ACTING CHAIR—I welcome back representatives from the Department of the Treasury, the Australian Government Actuary, the Australian Taxation Office and the Department of Family and Community Services. Since we last met, the minister has issued a number of press releases. Can you please state how that will impact on our deliberations today.

Mr Thomas—Before I get to that, Senator, could I please make a short opening statement addressing a number of issues that were raised at the committee hearing a fortnight ago.

ACTING CHAIR—Certainly.

Mr Thomas—The first issue I would like to address is the tax treatment applicable to term pensions. The second issue is to correct a misconception regarding the rate of tax applicable in relation to superannuation benefits in excess of the reasonable benefit limits. Firstly turning to the taxation of term pensions, I note that this is, perhaps unsurprisingly, a complicated area of law. In essence, a term pension is a pension that is not payable for the member's life. Where a pension is not payable for at least the member's life expectancy or 15 years and/or does not meet certain other pension rules, the pension is considered to be a noncomplying pension. This means that it will be measured against the lump sum reasonable benefit limit—currently $619,223—and the assets supporting the pension will be fully assessed for determining eligibility for age pension entitlements.

The tax treatment of term pensions for RBL purposes is still determined by reference to section 140ZO of the Income Tax Assessment Act 1936. You will recall that section 140ZO determines the capital value of a superannuation pension. Where the pension is not payable for life, section 140ZO(2) allows the commissioner to determine a method for calculating the capital value of a superannuation pension. The commissioner has done this through two tax determinations which essentially provide that the capital value of term pensions will depend on whether the pension is considered to have been purchased or not. A pension is regarded as being purchased when the rules providing the pension are based on an identifiable lump sum amount. The most common example is an allocated pension. The rules setting out the method of calculation for term pensions are contained in Taxation Determination TD 2000/29.

Where a pension is not considered to be a purchased pension, the commissioner has decided that the capital value of the pension is determined by reference to Taxation Determination TD 2000/28. At its simplest, this determination establishes that the capital value of the pension uses the basic formula contained in section 140ZO, with two exceptions: firstly, a different pension valuation factor is utilised and set out in the determination; secondly, the residual capital value of the pension is the present value of the residual future capital value of the pension. This is also calculated using a formula explained in the tax determination. The determination uses different PVF and RCV factors to take into account the fact that these pensions are paid for a limited period of time. It is important to note that where the pension is a complying pension then the residual capital value must always be zero—that is, the capital providing the pension must be consumed if it is to receive concessional tax and social security treatment.

As per the lifetime pension, inappropriate term pension arrangements can be obtained by manipulating the formula to provide a low annual value and through the use of large undeducted contributions. This will

provide a pension with a low capital value and enable the individual to compress their reasonable benefit limit. I note again that the assets supporting term pensions are still exempt from taxation on income they earn and, together with the residual capital value, allow opportunities for inappropriate estate planning. In relation to a noncomplying pension the rules may allow partial or full commutation of the pension, something that is prohibited for complying pensions.

There was also a concern about the implications of a five-year pension. As noted above, it remains possible for this pension to be brought below the lump sum reasonable benefit limit by manipulating the annual value aspect of the formula and by making large undeducted contributions. This means that the pension will be eligible for a full pension rebate. If the rules of the pension allow full or partial commutation then the benefit can be paid from the fund at any time. Thus it is possible to avoid excess benefits tax that would normally apply to lump sums.

There may conceptually appear to be less prudential risk—that is, there is perhaps greater certainty that the pension will be paid—where the pension is paid for a short period of time, such as a five-year term pension, but of course this would depend on the assets and the investment strategy of the fund. Consequently, there remains a concern that these pensions may be used for inappropriate tax-planning purposes. I will quote another promoter in relation to fixed term pensions:

> For the trustee of a self-managed superannuation fund, provided they use an actuary, fixed term pensions are a valuable tool when it comes to estate planning. The fixed term pension is the best tool for the trustee to look after a member's family. It could be for two years or it could be extended to more than 50 years, provided the actuary allows, thereby travelling two to possibly three generations.

Finally, in relation to term pensions, it is important to note that this issue will be considered in the government's review of defined benefit pensions. Details of the review were announced by the Minister for Revenue and Assistant Treasurer, Mal Brough, on 5 August.

Turning to the taxation of excessive benefits, it was asserted at the previous hearings that retirees face a tax rate as high as 78 per cent on excessive benefits. This is incorrect in relation to the payment of both lump sums and pensions. I will address lump sums first. There are four factors that influence the overall tax rate on an excessive ETP paid from a superannuation fund. The first is the tax levied on the excessive benefit. Prior to November 2003, this was 47 per cent plus the Medicare levy. However, the government announced as part of its 2001 election commitments that it would reduce that rate to 38 per cent plus the Medicare levy. This was to prevent effective tax rates beyond the top marginal tax rate of 47 per cent applying to these benefits. The second factor is the contributions tax of 15 per cent. The third factor is the superannuation surcharge of 12.5 per cent, which is down from 15 per cent and falling to 10 per cent in 2005-06. Finally, the fourth factor is the amount of earnings and the tax levied on the earnings, which can be anywhere between zero and 15 per cent, depending on imputation credits and the CGT discount.

As stated in the previous hearings, these components cannot simply be added together to calculate their impact on effective tax rates. This is because the tax on excessive benefits is levied on the contributions after the contributions tax and surcharge have been deducted, while the contributions tax and surcharge are based on the initial contribution. There is a different treatment applying to excessive benefits paid as a pension. Benefits supporting a superannuation pension are exempt from tax in a superannuation fund, and income tax is paid once in the hands of the individual. To encourage the payment of complying pensions, the government provides a 15 per cent rebate if the pension is below the pension reasonable benefits limit. To the extent a benefit exceeds the pension reasonable benefits limit, it is intended that there be a proportionate reduction in the pension rebate. This is, of course, a key element of the inappropriate instances of defined benefit arrangements that form part of the discussion from the earlier hearing. This concludes my opening statement, and I hope it assists the committee. We are now happy to answer further questions.

ACTING CHAIR—I will come back to my first question. I understand the minister has issued one or a number of media releases impinging on this topic. How does what was included in those affect the outcome of this inquiry?

Mr Thomas—The main press release that the Assistant Treasurer issued was the terms of reference for the review into DIY super.

Senator SHERRY—What is the number of that?

Mr Thomas—That is No. 1, dated 5 August 2004. The media release provides the terms of reference for the review, which is going to be conducted by the Treasury and the Government Actuary in consultation with industry and other interested parties. It is inviting submissions from interested parties on the issues that are

stated in the terms of reference. That covers the access to tax and social security benefits, the use of these products for estate planning purposes and whether a small number of members can effectively pool risk and guarantee income payments over the term of the pension. The government has invited comments from interested parties on these issues up until 1 October this year. Following that, there will be discussion between the review team, people who have made submissions and other interested parties. That will lead to the development of a discussion paper, which will be issued for public comment. Ultimately, it will lead to further advice to government in the first quarter of next year, which will provide some recommendations as to what the government should do further in relation to this matter.

The transitional regulations, which the government introduced last month, provide the mechanism to allow this further review to take place, putting a hold—as we have noted before—on the availability of these products to members who are going to retire before 1 July next year. Prior to 1 July next year the government will have completed the review, made recommendations and introduced any further regulations or legislation that might be necessary following that review. It sets the framework to enable people to comment on many of the issues that are the subject of this inquiry. Obviously, this inquiry relates to the two sets of regulations that have been made to date. This review will consider a number of those issues further and make recommendations to government, which may lead to further developments prior to 30 June next year, when the transitional regulations expire.

ACTING CHAIR—In terms of guidance to the committee, given the developments that have taken place since we last met on the issues that have been raised by a committee and which we intend to pursue further today, your suggestion—as I understand it from what you have said this afternoon, Mr Thomas—would be for us to recommend that the regulations remain in place until the review takes place to ensure there is no possibility of exploitation as a result of the delay. Is that the case?

Mr Thomas—Certainly. Under the transitional regulations that are in place, those people who are retiring before 1 July next year are in essentially the same position as they were before the budget announcement and the making of these regulations. The intention is that—

Senator CHAPMAN—Can I intervene there. They are not in exactly the same position, are they?

Mr Thomas—No.

Senator CHAPMAN—That is a misstatement of fact.

Mr Thomas—I think effectively they are in the same position.

Senator CHAPMAN—No, they are not. We already established at our previous hearing that they are not.

Mr Thomas—I do not accept that.

Senator CHAPMAN—We did, because if they alter their pension, for instance, that is regarded as a change that is not allowed under these regulations. That is one point that was clearly established at those hearings.

Ms Lejins—The transitional arrangements operate independently from the grandfathering arrangements.

Senator SHERRY—I think Senator Chapman is right. Under the new regulations, if a person takes out arrangements in the next year and purchases a pension from a retail provider it is very difficult for them to unravel that arrangement if the regulations are changed again next year. In practice, it is very difficult. They will have signed a contract and signed up to an additional contract for another pension. How do they unravel that, in practice, if the regulations change?

Mr Thomas—The government has said that these pensions are permitted to be entered into by people who are retiring before 1 July next year. So there is no expectation that they would have to unravel them. The government is clearly saying—

Senator SHERRY—I know that. What I am saying is this: in the next year these individuals—because they are not sure what the regulations, the law, will say after this review process is completed next year—who are in the DIY will go and buy a pension from a retail provider. There will be a contract signed and they will pay their fees and whatever is involved. Let us assume the regulations do change. In practice, how do they unravel the arrangement they have entered into?

Mr Coles—Technically, they can commute the pension and purchase a new one.

Senator SHERRY—Technically?

Mr Coles—In practice, that is what they can do. The other issue is that this allows the small fund to commence the pension. That pension will continue to be paid under the same terms and conditions that they want to achieve.

Senator SHERRY—Mr Smith retires at the end of this year. He enters into a new contractual arrangement with a retail provider as an add-on to his DIY. He signs on the bottom line and pays the fees and charges. The assets are moved over into this product. In practice, if the regulations change—and the point is premised on the regulations changing next year—it is very difficult for them to unravel the arrangement. Sure, in law they might be able to unravel it, but who is going to unravel a new contractual arrangement? There might be penalty provisions and exit fees. Who knows what might exist? In practice, it will be difficult to turn back the clock for this group of people.

Mr Coles—They might be in a very good arrangement that they are quite happy with and they may not want to unravel it.

Senator SHERRY—Yes, but if they wanted to do so it would be difficult. The point I am getting at is that we have an unsatisfactory situation where you are asking us to maintain the existing regulations, to keep them in law, and then around the middle of next year these regulations may change again. There is legislative uncertainty. We have got the process around the wrong way. I do not have a problem with the process you have outlined, but it seems to me that it is the sort of process you would enter into before the gazettal of regulations.

Mr Coles—I guess there are elements of that, in the sense that the government decided to address a tax planning arrangement—

Senator CHAPMAN—That is overstating the position.

Mr Coles—It is the government's position, Senator. If you have a look at the budget papers, you will see that they say that they are addressing a range of arrangements that were providing inappropriate tax, prudential and social security benefits.

ACTING CHAIR—Senator Chapman, please allow Mr Coles to answer Senator Sherry's question. You can then have the next one.

Senator CHAPMAN—You do not get sympathy for your position by making those sorts of comments.

Senator SHERRY—Do you think that, in a retirement income world where people would like a reasonable degree of certainty, it is a good idea to have one set of regulations and the possibility at least that the regulations may be changed in some form a year down the track? Do you think that is a good approach?

Mr Thomas—I think they have good certainty that, if they enter into these arrangements before 1 July next year and they are retiring, they can continue with the arrangements. There is not an expectation that they are going to have to wind up those arrangements or enter into anything else.

Senator SHERRY—That is not what I am arguing, Mr Thomas. My argument is: if the regulations change in some way next year—they may change—they may want to unravel their arrangements, but in practice it is very difficult to unravel the new arrangements.

Mr Thomas—As Mr Coles said, they could commute and roll over into a new product.

Senator SHERRY—Yes, but that would involve fees and extra contractual obligations. That is not a very satisfactory position for an individual to be in.

Mr Coles—One of the major criticisms of these measures was that we were forcing people into the arms of the life companies. One of the issues was that these funds should be able to provide their own pension within the fund. We are allowing the small funds to continue to provide their own pension within the fund. So there will not be, supposedly, the impact of excessive fees or charges imposed by the life companies; they are just not there, because it is provided within the fund. The major criticism has been dealt with by the government, by allowing the transitional arrangements for these defined benefit pensions to be provided within the smaller fund.

ACTING CHAIR—I take Senator Sherry's point, but why would a person want to unravel, in the nature of Senator Sherry's scenario, if they can just proceed as normal because they have been given an extended time? I cannot see the need for people wanting to unravel if they can proceed without having to unravel. I would have thought the normal person would just seek to take advantage of the extra time and proceed as if nothing had happened. However, I do concede that there is a problem if people want to unravel.

Senator CHAPMAN—I am relying on my recollection from the previous year: wasn’t there a statement from you that, if at some future date they needed to adjust the level of the pension, that in effect removed them from this transition arrangement?

Mr Coles—The ATO have issued a determination to the effect that—or perhaps it is better that they answer the question themselves—

Senator SHERRY—That is an invitation, I suspect, so perhaps they should now join you at the table.

Mr Coles—I think so. I think the example in their determination was along the lines that, if the pension suffered a catastrophic investment failure and the actuary decided that they were unable to pay the pension, they would have to start a new pension and they would not be able to do it under a defined benefit fund. I will leave it to the ATO to expand on that.

Mr Hanscombe—We have not said that you must commute a pension in any circumstance. We have not changed the rules in any way around when you have to commute a pension. We have simply said that, if under the existing law for whatever reason you have to commute a pension, that is a commutation and you should report it as such. There is no change in the law.

Senator CHAPMAN—I do not think we are talking here about commuting a pension; we are talking about the need to adjust the rate.

Mr Hanscombe—If you do not need to commute it, you would not need to rereport it.

Mr Coles—The terms and conditions of the pension are set out at the crystallisation of the contract. That means that the actuary sets out how the pension is going to be paid, the amount that is going to be paid and so forth. If that pension cannot make the payment and if the actuary then decides that that fund is unable to make the payment, that pension has failed. That is one of the concerns that we have expressed. At the lower end of the market, there is no insurance that these pensions will be paid for their lifetime, which is an expectation for the payment of a complying pension.

Mr Hanscombe—As to the complaints in the process, if you have a catastrophic investment return problem, you are going to have to start a new pension. If you have a catastrophic investment return, there are probably quite a few things that you need to do. One of them is commute, but people do not seem to be addressing the fact that the worst issue there is that they have lost a lot of money. If their actuary says, ‘You are going to have to commute,’ then that may be the case, but the ATO have not entered into that. We are simply saying, ‘If you do commute, that is a new pension.’

Senator CHAPMAN—Which then does not qualify for the transitional arrangements.

Mr Hanscombe—No, it still qualifies for the transitional arrangements between now and 30 June. With a few conditions, if you were a member on 11 May, you can change the terms and conditions 365 times between now and 30 June.

Senator CHAPMAN—I mean post—

Mr Hanscombe—Post 30 June, if you lose all your money, you may have to commute.

Senator CHAPMAN—And then there is no capacity—

Mr Coles—No, there will be a capacity to start a complying pension. It will be a market linked income stream, not a lifetime pension.

Senator CHAPMAN—Exactly.

ACTING CHAIR—Perhaps we should allow Mr Thomas to continue his presentation, which was interrupted.

Mr Thomas—There is nothing else that I want to add there in relation to the media release.

Senator CHAPMAN—Can I take it from what you said that the intention, in 12 months time or thereabouts—or less than 12 months—would be to in effect withdraw these regulations and substitute alternative regulations?

Mr Thomas—It is hard to see at this stage what the outcome of the review will be. If the issues that have been highlighted under the terms of reference can be overcome in relation to those concerns about RBL compression, inappropriate estate planning and the ability of these funds to provide a satisfactory level of certainty that these pensions will continue to be paid, then there may be scope—and that is to be worked

through in consultation with industry and others—to permit new types of pensions for small funds which meet the complying test characteristics. But that is yet to be determined as part of this.

Senator SHERRY—I understand that, but why not withdraw the regulations in the meantime?

Mr Thomas—Because transitional arrangements are in place which enable those people who are going to retire before 1 July next year to still access pensions that were in place before budget night. It is not just issues to do with complying pensions that were subject to those regulations; there were also matters around forfeiture of benefits, contributions to reserves and so on that were part of those regulations and are not part of the scope of the terms of reference in relation to defined benefit pensions. The government's view is that the restrictions put in place in those other areas need to continue and therefore the regulations need to continue. The area of concern around defined benefit pensions has been addressed through the transitional regulations.

Senator SHERRY—Just on that issue concerning the areas that are not the subject of the review, what is the revenue at risk as a result of those other regulations?

Ms Nicholson—We do not have precise numbers for revenue at risk, but we know that people were avoiding surcharge liabilities. Certain moneys were not being put into their superannuation accounts—they were being left in reserves. So it is a matter of tightening up the integrity of the system, but we do not have the accurate revenue figures on that.

Senator SHERRY—Is that the only area of potential revenue loss?

Mr Hanscombe—Around contributions to reserves there could be revenue lost with financial planning advice around surcharge allocation. There is also revenue loss where employers argue that they can make multimillion dollar contributions into a superannuation fund and allocate it at will. The ATO view is that is not effective. As we said at the last hearing, whenever we put that view to specific taxpayers they decide that they do not want to challenge our view. Our view is that, if you want to claim a deduction for a contribution in relation to the age based limit of a specific employee, the money needs to go into the account of that specific employee. If you want to just allocate it into a reserve then we will not apply it to the age based limit for any particular employee. There are a few people out there in industry who dispute that.

Senator SHERRY—Why is the regulation necessary? If you believe the law is sound in this area and you advise people accordingly, why is it necessary to upgrade the regulatory controls?

Mr Hanscombe—Providing an absolute statement in black and white that there is no way you can do this quite often saves a lot of compliance dollars in chasing these people.

Senator SHERRY—But you have just suggested you are doing that. If someone raises the issue with you, you are saying, 'No, you can't do it.' It is pretty black and white.

Mr Hanscombe—But having absolute clarity out there is a lot better than having—

Mr Coles—There are other issues as well.

Senator SHERRY—I am just dealing with this issue at the moment.

Mr Coles—The measures also address the forfeiture of benefits. The common example would be that I have $1 million in my superannuation fund and I forfeit half of those benefits to my spouse and thereby I fall below the lump sum RBL. We have stopped that arrangement—it is a very simple arrangement that has been around for quite a while—simply by ensuring that the contributions that are made to me are allocated to me and become my personal contributions as such. You cannot forfeit minimum benefits.

Senator SHERRY—But you can split your RBL if you get divorced, can't you? I would like to see you try to stop that one! That is the reality of the world.

Mr Thomas—It is government policy in that respect.

Senator SHERRY—What, not to discourage divorce?

Mr Thomas—No, the splitting of benefits in that situation.

Senator SHERRY—You can split an RBL through divorce, can't you?

Mr Thomas—Most people would not want to go down that route.

Senator SHERRY—I am not objecting to it, but that is the reality.

Mr Burt—I think there is a provision in the Family Law Act to take action against that as well.

Senator SHERRY—I would love to see you enforce that one!

Mr Burt—I am not going to try! You would have to check that, but I believe there is a provision to that effect.

Senator SHERRY—Good. As I say, I look forward to you enforcing that one!

ACTING CHAIR—Treasury have submitted three papers supporting their position: firstly, ‘Superannuation 2001, Between the Flags: Hyatt Regency Coolum, 22 to 24 March 2001’; secondly, ‘Superannuation 2002, A National Conference for Lawyers, Session Five, Superannuation as a Member Wealth Creation Device: Part 1—Accumulation Phase’, by Andrew Fairley; thirdly, ‘Holding Redlich: Self-Managed Superannuation Funds: Strategies to Prosper: An Update: FPA Convention, Melbourne: Presented by Gary Riordan, Partner, Holding Redlich Lawyers: 1 May 2004’. As these papers have just been given to the committee, would anybody like to quickly, for the *Hansard* record, give us a thumbnail sketch of what these seminars contrive to do? Before you answer, is it the wish of the committee that these papers be accepted as part of the committee record? There being no objection, it is so ordered.

Senator SHERRY—What do these papers highlight? What is the purpose of them?

Mr Coles—Essentially, the papers provide a fairly brief description of the arrangement and how it can be used. This is a promotional document, so it is not just the technical people looking at how to do it. The arrangement was explained and exposed to a variety of people, from superannuation lawyers to financial planners.

Senator SHERRY—What practices does this highlight?

Mr Coles—This is the defined benefit pension arrangement. It also provides an exposition, I guess, from an actuary as to the arrangement and how the defined benefit pension arrangement can be used for a variety of circumstances. In one example it takes a lifetime pension from $2 million to $6 million over a 40-year period. The third example, by Gary Riordan of Holding Redlich, is there to show that it was for more than just the superannuation lawyers; it was for the financial planners as well. They are just some basic documents. I took on notice at the Senate estimates hearing to provide one of those papers, the Andrew Fairley document, to the committee, so that is why it is there as well.

Senator SHERRY—Can I very quickly come back to the previous discussion we were having about the withdrawal of the regulations. It is perfectly possible, though, for the current set of regulations to be totally withdrawn and for a new set of regulations to be substituted, covering the issues we were discussing a little earlier and excluding those matters that are under review, isn’t it? It is perfectly possible.

Mr Thomas—Certainly. New regulations can be made and old regulations withdrawn. That is quite possible, I understand. I am not a lawyer, but I understand that is the case.

Senator SHERRY—To keep in place the changes to the areas that are not in contention, if you like, for the purpose of this hearing, that is a solution if the government wish to do that?

Mr Coles—With one proviso: regulations cannot be made retrospectively unless they benefit people. There are issues in disallowing the regulations.

Ms Lejins—There is a risk, if the regulations were withdrawn, that people would write terms and conditions for future pensions into their trust deeds so that they would in effect have permanent grandfathering.

Senator SHERRY—You could regulate against that, couldn’t you? You could regulate against change against the regulations for the period?

Mr Coles—You would probably need to talk to the office of legislative design on that, if we did it by regulations—

Senator SHERRY—I am surprised you have not done that already.

Senator CHAPMAN—On the same issue: isn’t it true that, if a person starts a do-it-yourself fund on or after 12 May this year and they want to start a complying or defined benefit pension, they cannot take advantage of the transition period?

Ms Lejins—They would need to have been a member of the self-managed fund on 11 May.

Mr Coles—You are correct, Senator.

Mr Hanscombe—The regulations do not grandfather funds that were not born on that day.

Mr Coles—Essentially, what the government was intending to do was to assist those people who had a clear intention to retire within their small fund to take advantage of the transitional arrangement. I guess the government considered there were constraints in drawing a line in the sand to assist those who maybe had not finalised their plans to enter into the transitional arrangement to the extent that it becomes a mechanism to avoid the intention of the law.

ACTING CHAIR—It is not quite as easy as that, because there are very much stricter rules to ensure the wording of the trust deed is very specific in terms of the ability of a person to take a pension. While it is generally available if the rules are clear and detailed, for a person who wants to take a pension after the commencement date there are very tight rules in the requirement for the trust deed to be very specific in relation to the taking of a pension and what that might mean. As I understand it, it is not just to facilitate those who retire after that date. In a sense that is true, but there is also the requirement for tighter audit trails for the Australian Taxation Office to pursue to ensure the pension is eligible in terms of the adequacy of the wording of the trust deed.

Mr Coles—I am not sure that is correct.

ACTING CHAIR—That is what I want to clarify.

Mr Coles—What we mentioned in the explanatory statement to the regulation was that under the current law you need to report your benefit to the tax office within a month of the pension commencing. That is the current law under 140M, from memory. It is no different from that.

ACTING CHAIR—This refers to the specifics within the deed of an ability of the fund to pay a pension. It cannot just be a general or simple reference; it has to be backed up by a fairly prescriptive arrangement.

Ms Nicholson—In terms of the original regs, that is correct, but the transitional regs ease that requirement for the period of the transition. So you can still have a very general trust deed and access a defined benefit pension up until the transitional period runs out.

ACTING CHAIR—So there will not be any detailed auditing, in other words.

Ms Nicholson—I would not go that far.

ACTING CHAIR—You say there is a general non-application.

Ms Nicholson—The transitional regs ease the requirement to have your pension specifically detailed for that grandfathering period. The grandfathering cuts in after the transitional period.

ACTING CHAIR—Why will you not go that far and say that the Audit Office will not be following up and looking at the details of the trust deed?

Mr Hanscombe—We are not sure exactly what your question is, Senator. At the moment funds are allowed to change their trust deeds, so I am not sure what we could audit.

ACTING CHAIR—I am interested in following Ms Nicholson's line.

Ms Nicholson—What we are saying is that the transitional regs ease the requirement to have the specific pension details for the period of the transition. I have not said we would not audit people, but audit conditions would be somewhat different to when the transitional regs cut out next year and the grandfathering provisions come in, and you do have to have very specific rules around your pension payment.

Mr Coles—I think also that the government, in its announcement of the transitional regulations, identified that this was a continuing area of concern and that it would be paying close attention to market developments and the operation of the rules and laws applying to these pensions. I do not think we can rule out that the ATO may consider undertaking an audit program.

ACTING CHAIR—Your advice to the committee is such that these people will not be disadvantaged—that is, people taking a pension after the budget date announcement and before the end of the transition period—in terms of the requirement for the trust deed to be quite detailed and prescriptive?

Mr Hanscombe—Again, from a legislative point of view, you can change your trust deed at the moment in a manner sufficient to set up a defined benefit pension through an SMSF, which is what the government specifically provided for. Until 30 June next year you are not disadvantaged in any way that I can think of.

Senator SHERRY—That is why you should withdraw the regulations and substitute a new set to cover the areas that are not covered. What is the difference in terms of the practical outcome?

Mr Hanscombe—You are asking me what the government should do with regs. What area is not covered legislatively?

Senator SHERRY—What is the difference if you withdraw the regulations and substitute a new set—other than the retrospective issue, and you may or may not be able to deal with that—on the issues that are not subject to the review?

Mr Thomas—The government, by issuing the transitional regulations, indicates that it does not believe that it is necessary to do that. The transitional regulations are appropriate and they should stand as they are. The other issues that are not covered by the transitional regulations continue in place. I do not see that there is a need to do that.

Senator SHERRY—But the complexion of the Senate changes, doesn't it?

Mr Thomas—That had not occurred to me.

Senator SHERRY—It had occurred to me and it is a sure bet that there will be at least some changes in the Senate after 1 July next year.

Mr Thomas—Point taken.

Senator SHERRY—In reality, once you have a set of regulations in place it is pretty damn difficult to change them a year down the track.

Mr Thomas—New rules can be made at any time. The government at the time will consider the outcome of the review and determine what the appropriate course to adopt is.

ACTING CHAIR—I have some questions that follow on from our discussions last time. When we finished last time we were talking about the CPA submission—a submission that not everybody from Treasury had read. In that submission the CPA state:

> We understand the requirement for all contributions to fully vest in the member is aimed at addressing superannuation surcharge avoidance and deductions claimed inappropriately for contributions. However, these issues do not generally arise through vesting, but in the way contributions are allocated within a fund.

They went on to explain:

> ... Division 7.2 of the amended SIS Regulations requires the contribution received in the month to be allocated to a member within 28 days of the end of the month. However, it does not require the contribution to be allocated to the member for whom it was intended or for whom a tax deduction was claimed.

Ms Lejins responded that the tax office had already clarified that this was not an issue. The person to whom the contribution was allocated must be the person for whom the tax deduction is claimed. There is no opportunity to allocate to a member other than the member for whom the deduction is claimed. My question is: if this is so, why was the change to the legislation necessary in the first place? The new regulations certainly do not say that a contribution is to be allocated to the member for whom it is made.

Ms Nicholson—This is the issue that Mr Hanscombe responded to Senator Sherry on a few moments ago. From the tax office perspective, we think that the regulations add clarity.

ACTING CHAIR—No.

Ms Nicholson—It is not the same issue?

ACTING CHAIR—No.

Ms Nicholson—I thought it was.

Senator CHAPMAN—This is about the 28-day rule.

Mr Hanscombe—It is to do with allocating contributions to a member.

ACTING CHAIR—That is right.

Ms Nicholson—To a member's account.

Mr Hanscombe—There are probably legal views that you can do any number of things when you look at that, but the ATO view is that if a contribution is made in respect of a particular individual it should be allocated to that individual rather than given to a member of someone else's fancy.

Ms Lejins—The regulations prevent deferral and avoidance of the superannuation surcharge, whereby the contribution is allocated to a reserve account either for the surcharge reporting period or, in some cases, an indefinite period. In addition, it also prevents contributions being allocated directly to expense reserve

accounts where those expenses may not be reported for surcharge purposes. An example is that the contributions tax could be directly paid to a reserve account and only the net amount of the contribution reported for surcharge purposes. So there are quite a number of abuses that the regulation is seeking to address beyond the avoidance of the deductibility limit practice.

Mr Coles—I guess there is a case of cherry picking as well. There are arrangements where, unfortunately, in the past, employers made contributions over and above the SG in respect of their employees and allocated SG to the members but did not allocate the rest of those contributions to them; they kept them for themselves to be paid out at a later date. This arrangement essentially, by identifying any contributions made in respect of the member, must be allocated to the member within 28 days. That coincides with trust obligations in respect of looking after the best interests of the member as well.

Ms Lejins—The requirement is also consistent with the Corporations Law requirements regarding the treatment of application moneys.

Senator SHERRY—So eight years on we are still fixing up the surcharge?

Mr Coles—I do not necessarily say it is fixing up the surcharge system; I think it is addressing inappropriate planning arrangements.

Senator SHERRY—Yes, fixing up the surcharge revenue base. That is what you are saying. Eight years on! We still do not have those state judges.

ACTING CHAIR—I might ask a series of other questions which arise from the initial problem. In the past when the Australian Taxation Office have been concerned about certain practices the office have issued public statements clarifying how they will interpret the law, which has generally been a very effective way of curbing undesirable practices. In this case, why didn't the tax office just issue a public statement confirming that they would not allow deductions for any unallocated contributions to accumulation funds unless made specifically to cover expenses? Wouldn't this have avoided most, if not all, of the problems raised by the Institute of Actuaries, the certified practising accountants and other submissions?

Further, what is the rationale for outlawing bona fide vesting arrangements? Is it not reasonable for employers to attach vesting conditions to contributions paid above the minimum superannuation guarantee such as rewarding employees for loyalty to the employer? And what is the abuse being targeted with respect to bona fide vesting arrangement contributions taxes paid by a fund when the contributions are made and also picked up by the surcharge reporting? If the contributions do not fully vest in the original member but are subsequently allocated to another member, are the same contributions potentially reported for surcharge a second time when the allocation is made to the next member? Where is the minimisation or surcharge avoidance if this is the key problem?

Mr Hanscombe—I will take the first question first. The ATO has already made it clear in public statements that contributions that are not allocated to members within their employees' age base limits are not deductible. There are clear statements on the record.

Mr Coles—The vesting regulations or the requirement to have the minimum benefits address a number of things. By putting the proposal forward, it does not stop forfeiture of benefits or cherry picking. These arrangements could still be in place. What the regulations do is make it absolutely clear that contributions made in respect of a member belong to the member. In relation to the remuneration of employees, there is a range of options to remunerate employees appropriately and through the superannuation fund, and this was one where we thought that perhaps it was better to make it absolutely clear that a contribution made in respect of the member belongs to the member—not at some vesting contribution in the future. We do continue to get the occasional ministerial and so forth emanating from a member of parliament and indicating that people were not aware that contributions made were a part of a broader employment arrangement and that those contributions were not directly allocated to them in their account so that when they left their employer their superannuation balances were a lot less than they thought.

I guess the government decided that—to address the tax arrangements, the broader issues and the fact that there are alternative remuneration practices out there—this is an appropriate way to address the concerns. In the regulations we provide that, where there is a vesting scale in place in the super fund rules, those arrangements are grandfathered. I understand that the regulator might be considering a modification declaration to address other circumstances where vesting arrangements are set out in one or more constituent document—whether that be the AWA or some other document.

Senator SHERRY—What are you talking about when you say AWA?

Ms Lejins—A modification declaration.

Mr Coles—I think I meant a certified agreement.

Senator SHERRY—You are talking about the industrial instrument of an AWA?

Mr Coles—Yes.

Senator SHERRY—Okay, I was not sure whether you meant the industrial relations acronym.

Mr Coles—Yes. The regulations are in an area that allows for the regulator, APRA—if a larger employer provides superannuation funds—to modify the law to address individual circumstances.

ACTING CHAIR—I want to come back to the grandfathering provisions. While I recognise that there is an attempt to grandfather funds with existing vesting arrangements in place, the Institute of Actuaries has stated that the provisions are so badly drafted that they will rarely apply. That is fairly strong criticism. In particular, it is unusual for there to be a written agreement between the employer and the member. It would be even more unusual for the agreement to specify the details as set out in regulation 5.08. I have a series of questions to give you. Firstly, what is Treasury's response to that? Secondly, the Institute of Actuaries has stated that if an employer is willing to contribute additional amounts over and above the minimal requirement for superannuation guarantee purposes this should encouraged. The institute said that it should be possible for the employer to put conditions on the benefits resulting from those voluntary contributions—for example, they could be used to promote employee retention. It is likely that many employers currently making additional voluntary contributions who partly vest contributions will cease or reduce those contributions if they have to be fully vested, which would be a worry. I ask then: is this a desirable outcome? Why is this considered to be an abuse that needs to be outlawed? If this is not the intended target of the regulations then shouldn't the regulations have been more specifically targeted to the problem area rather than taking a broad brush approach? Finally, why wasn't industry consulted prior to introduction to ensure that such unintended consequences were identified?

Mr Coles—I will respond in relation to consultation.

ACTING CHAIR—That was the last one.

Mr Coles—I will start with the easy one first in relation to consultation. It has long been government practice that you do not consult on integrity measures. There is a perceived integrity concern in relation to these arrangements, and so you address the law clearly and decisively.

Senator SHERRY—Why are you bothering to have a review then?

Mr Coles—We are talking about the vesting arrangements here.

Senator SHERRY—So you are confining this consultation—or lack of consultation—

to that issue?

Mr Coles—No. You are asking why we were not consulting prior to the release of the integrity measures. The government took the view that the law covering these arrangements needed to be addressed because of the tax consequences. The law also set out circumstances where legitimate and bona fide arrangements should be allowed to continue. There is a fairly diverse market out there and certainly it appears that we have not captured all of the circumstances where there might be bona fide arrangements. However, the regulator does have the power to issue modification orders on an individual or a class basis to deal with these bona fide employment vesting arrangements. I understand that APRA is considering issuing a modification declaration to address these circumstances where the arrangements are set out in one or more constituent document—whether that be a certified agreement, an AWA or some other paper—so that the employer and the employee are fully aware.

In relation to why the government took this action, I think that is a decision that the government took to address certain inappropriate tax planning arrangements. It perhaps has an impact on legitimate employment activities. However, the government was concerned that it needed to address the tax planning things. On the balance of consideration, it decided that it was more appropriate to look after the risk to revenue than the other employment arrangements when there are certainly a wide range of options to remunerate employees through bonuses and so forth.

ACTING CHAIR—So the traditional use of superannuation—to encourage employee retention—is now out of the window because some people have exploited other measures and this particular approach has been caught up in the net? Is that right?

Mr Coles—I think the government is taking the wider view that, on the balance of the risks, the protection of member entitlements and the full vesting of those member entitlements is a preferable outcome.

Senator SHERRY—So, from the tax office's point of view, in some cases AWAs are being used incorrectly through superannuation—there is a risk to revenue?

Mr Coles—I think there are inappropriate vesting arrangements—not necessarily in AWAs—whereby, as I explained before, the employee superannuation benefits were not what they thought they were because they were not made fully aware of the fact that it might be a vesting scale. We are putting in place a system whereby contributions made to the member are allocated to the member's account.

Senator SHERRY—You are saying not necessarily AWAs, but you referred earlier to the misuse of AWAs in some circumstances, didn't you?

Mr Coles—No, I do not think I did. I think we are talking about vesting scales where they could be put in place in other constituent documents—

Senator SHERRY—In AWAs.

Mr Coles—In an AWA. I did not say that an AWA was an inappropriate document or was being misused. I said that APRA may be considering a modification to the provisions where there is an appropriate vesting scale in perhaps a certified agreement or an AWA—that those arrangements will be considered appropriate. I think it is the converse of what you were just presenting to me.

ACTING CHAIR—So in a sense you would predict that employers would not be making arrangements to encourage retention of employees by giving conditional superannuation entitlements.

Ms Lejins—Voluntary contributions can still be made to an accumulation fund provided they fully vest in a member. That means that, if a deduction is claimed in respect of the member, that benefit must be credited to the member's account and also fully vested in the member. It cannot be forfeited to somebody else at a later point in time. A defined benefit fund can be still legitimately be used to provide partial vesting arrangements, but it must be done through a defined benefit fund and not through the accumulation fund.

Mr Coles—To summarise that: if an employer wants to suggest to the employee, 'We really like you; we want you to stay here and continue working for us, and we'll put money into your account,' the employee knows that. The employer can put in a voluntary contribution over and above that and that employee will know that that money is going to be in their account for their retirement.

ACTING CHAIR—If they stay an extra two years.

Mr Coles—No. Basically once it is paid into the account it is that employee's money. I cannot see that that is a bad thing.

Senator SHERRY—This is in respect of a defined benefit and not an accumulation.

Mr Coles—No, the accumulation—

Senator SHERRY—Sorry, accumulation and not a defined benefit.

Mr Coles—In a defined benefit fund there are different arrangements.

Senator SHERRY—So if it is paid into accumulation the employer cannot control it; if it is into a DB they can.

Mr Coles—Defined benefit arrangement funds are pretty much exactly these types of arrangements, where the final members benefit is calculated according to a formula—so if you have worked a certain length of time, this is the benefit you are going to obtain. What the inappropriate arrangements were doing was providing an opportunity for contributions to be allocated to a member or the avoidance of tax. That was occurring in the accumulation fund, which is why these regulations only apply to accumulation fund arrangements and schemes.

ACTING CHAIR—We have Mr Alex Dolan with us today from Centrelink and my next question focuses on Centrelink entitlements. At our last hearing, Treasury stated in their opening statement that Centrelink has approximately 3,000 customers who are receiving a defined benefit pension from a self-managed superannuation fund and who are in receipt of an age pension benefit. Would it be reasonable to assume in the absence of any evidence that many of these would be receiving a part age pension rather than a full age pension? And if they are receiving a part age pension, don't these figures actually show that the social security and superannuation systems are starting to work as intended—that is, people are starting to use their

superannuation to draw an income stream in retirement and are only relying on partial government support rather than spending their lump sum on retirement and relying on full age pension support? On the question of wealthy people accessing their superannuation, won't the reduction in the assets test exemption from 100 per cent to 50 per cent from 20 September 2004 address Treasury's concern on this front? Mr Dolan, are there 3,000?

Mr Dolan—Our records suggest that on Centrelink's database there are approximately 1,500 income streams that commenced after 20 September 2001 and are recorded. It was not possible for Centrelink to advise as to the number of self-managed superannuation funds that commenced before 20 September 2001 but estimates from the government actuary suggest that there could be a further 300. So there are about 1,800 that we know about on our records. The figure provided, I believe at the last hearing, of approximately up to 3,000 may have been an upper bound just in case—

ACTING CHAIR—May have been?

Mr Dolan—I understand there was a figure quoted of 3,000 at the last hearing?

ACTING CHAIR—Yes, that is right.

Mr Dolan—In a sense that may be some that we have not quite captured in the system. Certainly, we have a fairly firm estimate of 1,800, there is a possibility the estimate could be higher and 3,000 would be an upper bound. In respect of the other questions you raised, you asked two other questions and one was to respond to the comment—

Senator SHERRY—Sorry, but could we clear up this issue of numbers because I was going to ask some questions about this? Let us deal with the 1,500 since 20 September 2001.

ACTING CHAIR—It is 1,800.

Senator SHERRY—Let us say it is 1,800 if we say there were approximately 300 prior to that date. Are these numbers increasing each year? Is that your observation? Do you have a year-by-year figure?

Mr Dolan—I have a point in time figure. We understand that the trends in self-managed superannuation funds for social security purposes would be similar to the trends in self-managed funds in terms of growth. I do not actually have an estimate around that; it is just an inference on the basis of general trends in the industry that we expect it to have been going up. The figure that I have for you is a point in time figure of funds reported.

Senator SHERRY—Are you able to provide us with any breakdown on the level of pension access that these income stream products are receiving?

Mr Dolan—What we do have access to concerning the self-managed super funds are details of the purchase price and the incomes that those funds generate. In respect of an individual person on the pension, their pension is also determined by any other income or assets that they have. That is a further step that we have not done.

ACTING CHAIR—We are interested in the fact that there is not an automatic assumption in these figures that people are getting 100 per cent age pension. They could be getting a pension of $5 a week, for example. We are saying, 'Isn't that a good example of how the superannuation guarantee system is interacting with the age pension?'

Mr Dolan—That is right, to the extent that, to receive a full age pension a single person's income must be no more than $122 a fortnight—that is, about $61 a week—and for couples it is about $108 a week or $216 a fortnight. So if people have been earning more than that from their assessable income—from their income stream and from other income—they will be on a part pension. For the aged population as a whole, one-third of aged pensioners are currently receiving a part rate of pension and that would include people receiving money from income streams. So, as you say, that is an example of where the superannuation system and the age pension interact because you have had people receiving income from their income streams and their income is assessed and that reduces their pension.

ACTING CHAIR—We are saying that that is a good thing.

Mr Dolan—That was the intention of the superannuation legislation and the age pension legislation: to provide people with more income than the age pension alone can provide.

ACTING CHAIR—So the 3,000 people—or the revised 1,500 or 1,800 people—are not necessarily full aged pensioners?

Mr Dolan—That would be right. It would depend on their income, of course.

ACTING CHAIR—So there would be a range of persons—maybe one or two at the top end—and there could be people who are receiving $1 or $2 a week pension?

Mr Dolan—It would depend on their income from their income stream and any other income or assets that they hold. The outcome would depend on the culmination of those factors.

Senator SHERRY—That is right; I understand that. Let us say that there are approximately 1,800 persons. How many of those 1,800 have you identified—on the available evidence—who are abusing the system?

Mr Dolan—How do you define 'abusing the system'?

Senator SHERRY—Receiving a pension, or a part pension, when it was not the intention that they should be.

Mr Dolan—I said that people would be receiving a pension, as determined under the relevant social security legislation. People would be receiving age pensions on the basis of the legislation, so the legislation would be looking to Centrelink in assessing a person's entitlement to an age pension. You probably know this, but they look at their assessable assets, not including their home, and of course currently not including asset test exempt income streams, although that will change from 20 September 2004. On the income side, Centrelink would be looking at their assessable income from any income streams or other forms of income they may have. So you assess a person on the assets test and the income test, and the test that produces a low rate of pension is the one that applies. These people who have been receiving an age pension and an income stream will be people who will be receiving a pension under the social security legislation.

Senator SHERRY—Can you give us some evidence of abuse in this area with respect to people who should not be collecting the age pension in part or in full, as a consequence of their income from self-managed super funds?

Mr Dolan—It is a difficult question to answer because these people are receiving an age pension under the legislation. The purpose of the regulations put forward by then Minister Coonan was to change the way in which people with self-managed superannuation funds can convert the money into an income stream. At the moment the data that we have would relate to people who have already purchased an income stream and so, in a sense, under the laws and the regulations applying at that time they are receiving a lawfully entitled pension.

Senator SHERRY—Can you identify, in terms of the growth that has occurred in this area, what the impact on the growth of claim will be, assuming these regulations continue?

Mr Dolan—I do not have that information. You are trying to assess—

Senator SHERRY—The impact of these regulations on people claiming, through self-managed super funds, a full or a part age pension. Do you know?

Mr Coles—More or less under the original regulations a line was drawn. These funds could not provide a defined benefit pension—a complying pension. Therefore, those assets supporting that pension would be fully assessed and any income would be fully assessed or would be assessed under those rules. Under the transitional arrangements that allow funds to continue to provide these pensions, I am not sure we are in a position to guesstimate in the future the number of people who are—

Senator SHERRY—Or estimate.

Mr Dolan—It is also about protection, as Treasury people have said. It is an integrity measure. It is designed to protect the integrity of the system.

Senator SHERRY—I understand that. Give us what you believe is the evidence where the abuse is occurring. That is all I am asking. Give us the evidence.

Mr Dolan—I do not want to use the term 'abuse'. In terms of some of the issues that have arisen in respect of self-managed super funds, there have been about a dozen self-managed funds that have to be commuted—

ACTING CHAIR—Order! The hearing will have to be suspended. There is a division in the Senate.

Proceedings suspended from 4.51 p.m. to 5.06 p.m.

Senator SHERRY—We were just about to hear from Mr Dolan about the level of abuse and to get some details and some facts on the record.

Mr Dolan—Again, not using the term 'abuse' but rather framing the response in terms of some issues around the risk associated with some of the self-managed superannuation funds, as I indicated, to date about

12 self-managed super funds have had to be commuted and rolled over to a new fund because of the failure to meet solvency requirements. In one particular case one income stream had to be commuted and recommenced twice in two years to meet solvency. I admit that 12 out of 1,800 is a pretty small percentage, but it should be said that self-managed super funds in the main have only been delivering income streams for up to five or six years and most for much less than that. So within five or six years the evidence suggests that a small number—12—have already had to experience solvency issues. The risk therefore is that if left unchecked that number could grow as they move further down the income stream and, of course, more products will be coming on from the accumulation stage to the payment of income stream stage. The evidence thus far suggests the concern that there may be significant instability with a small product involving a small number of people offering an insurance based lifetime or life expectancy income stream is there. The data suggests there is evidence there of something that has been borne out. That is the first element of concern.

Senator SHERRY—That is the issue of effectively pooling risk. What I am trying to get to is inappropriate access to social security benefits.

Mr Dolan—I can answer that in the second element of my response. We have sought to compare the average purchase price and the average assessable income of asset test exempt income streams offered by retailers such as AMP and other such organisations and by self-managed superannuation funds. So this is data that goes to income streams purchased or commenced from 20 September 2001. In making any of this sort of comparison you are always subject to a lot of assumptions and uncertainties because you are picking things to a particular point in time, but a common trend among the data is that, for a given purchase price, small fund income streams are delivering significantly less average assessable income.

For example, significant numbers of people have a purchased asset test exempt income stream valued at, say, between $100,000 and $250,000. For those purchased from a retailer such as AMP, the average assessable income per year is about $3,000, and, for those purchased from a self-managed super fund, it is about $1,300—it is about a third; it is significantly less. There may be all sorts of reasons why there is a difference. I am not saying that it is necessarily inappropriate. It could be the way that the funds have been particularly structured. The data is suggestive—is suggestive only—that, in relation to a product with a similar purchase price, the assessable income produced by self-managed superannuation funds has been less than the income produced from a retail income stream. That is suggestive only.

Senator CHAPMAN—I have data that is contrary to that, which I will present later.

Senator SHERRY—Did you say $3,000 and $1,000 per year?

Mr Dolan—Yes.

Senator SHERRY—That is income?

Mr Dolan—Yes, assessable income. The numbers of course are varied, depending upon the purchase price of the product, but there is that pattern, which is, as I emphasised, suggestive only. It is not inconsistent with some of the concerns of self-managed super funds. Because they are small, obviously there is a reserving issue to ensure that they can meet the income streams promised, which may have an impact on their capacity to produce income for the pensioner. We have two elements of data: one, as I said, is in respect of the funds that have had to be recommuted and the other is in respect of income trends.

Senator SHERRY—Just coming back to the earlier issue you mentioned about 12 funds failing to meet solvency requirements, isn't that a problem rate, if you like, if we take $1,800 of less than one per cent?

Mr Dolan—That is right.

Senator SHERRY—I just want to get to this issue of risk. Let us assume that these people were going into a growth pension.

Mr Dolan—I should say that, in relation to that risk, most of these products have not been operating for five or six years.

Senator SHERRY—I understand that.

Mr Dolan—So it is a very small percentage, but of course, as these products go on, it would be expected that, if products run into solvency issues, it could be 10 or 12 years out. It is hard to tell, but we may have been seeing only the beginning of the trend, but that is an element of risk.

Senator SHERRY—Perhaps. I do not know what the actuary is doing; they are obviously doing something wrong. Let me come to the issue of risk. You have highlighted the risk—that is, to date, 12 out of 1,800 have

been affected. But hasn't the individual chosen to carry that risk, obviously certified by an actuary and an accountant? That is the risk that they have chosen to carry.

Mr Dolan—That is true, but under the social security system, to encourage the purchase of complying income streams, there is an asset test concession, which is a 100 per cent asset test exemption, over the period we are looking at and it will be 50 per cent into the future. The purpose of the asset test exemption or the asset test concession, as it will be, is to encourage people to purchase products that will give them a gradual drawdown of their capital over their life expectancy into retirement or over a lifetime product. In return for that asset test concession, the expectation is that that income stream will in fact last throughout the period that it is expected to last for. Where a product is a priori, by definition there is an expectation that there will be risks in meeting that promise because there are so few members of the fund with whom to pool the risks. There is an expectation of risk, and the early indications are that the risks are being borne out by some funds.

Senator SHERRY—But we have a system where the actuary and the auditor are supposed to sign off on this. What are they doing?

Mr Dolan—The Government Actuary may want to jump in here, but for a self-managed superannuation fund an actuarial certificate is required to say that there is a high probability that the fund will meet its promise—that is, about 70 per cent. There is a residual probability that it will not meet the promise, and there is always a risk of investments turning bad or things not working out as intended. If you have a smaller pool, there is less chance of pooling that risk and a greater chance of the fund not succeeding, as opposed to a larger retail fund, where there is a greater risk pool, a greater pool of customers on the issue of risk.

Senator SHERRY—Isn't there an element of risk with these new growth pensions which are being touted as a great nirvana for retirement incomes?

Mr Dolan—But it is a different type of risk. The growth pension—or I think 'allocated product' is the new industry terminology now—is a different sort of beast altogether.

Senator SHERRY—But there is a risk to them, isn't there?

Mr Dolan—There is, but the risk is very clear.

Senator SHERRY—Is it?

Mr Dolan—It is not an insurance risk; it is a risk that the product is so defined that it will last the term or the life expectancy, but the income stream a person gets in each year will be determined by the account balance more or less at the beginning of the year. So, in a sense, the end point is fixed but the amount of pension you get in each individual year will vary.

Senator SHERRY—So there is a risk.

Mr Dolan—There is a risk of that but, with the lifetime or the life expectancy, you are talking about a product which offers a guaranteed income per year for a guaranteed number of years. It locks you into a much more certain future level of payment and therefore a much greater sense of risk. That is why these products are offered by insurance companies—because, if it is insuring, it is insuring that you can actually deliver those payments over a term as promised. It is quite a different animal to a growth pension.

Senator SHERRY—I understand it is a different animal, but the issue of risk is still there in a growth pension. It is a different type of risk.

Mr Dolan—It is a different type of risk but these risks—

Senator SHERRY—Nothing is riskless in this world.

Mr Dolan—No, but these products have been given an asset test concession because the promise to pay the individual—

Senator SHERRY—I understand the issue of the asset test pension, but I am not coming to that at the moment. I am looking at the issue of risk. If these individuals, signed off by an auditor and actuary within the rules, take the risk that to date there is a failure rate of about 0.8 of one per cent, what is the problem? If they are prepared to bear the risk that there is going to be that failure rate within the current rules, why shouldn't they be allowed to continue that?

Mr Coles—Part of the answer to that is they do not necessarily bear the risk; the rest of the community bears the risk.

Senator SHERRY—Because of the possibility—

Mr Coles—The government is the provider of income of last resort through the age pension. If these funds fall over, there will be an increased call on the revenue, so this is part of the issue that we touched on before of balancing.

Senator SHERRY—Okay. Let us look at the call on the revenue. We have 12 to date. I do not know what has happened to these 12 people. Can you give me the actual extra call on revenue as a result of the age pension of these 12 funds going under? What is the extra call on revenue?

Mr Dolan—The call on the revenue, in terms of the $20 billion in age pension expenditure, for those 12 individuals would be negligible. One expects that they will be having a lower income stream, but that is not the point. The point I was making was that there is an expectation that offering an insurance based product with a very limited number of members from which to pool the risks is inherently risky of itself. The evidence is that, with just five years of experience—which is a very short time in terms of the term of these products—some have already fallen over. The risk is that as time goes by more may fall over. Also many more income streams from self-managed funds, if left unchecked, would have come into the system, so you would numerically expect to see far more. Even if the percentage that we see today had been maintained, with the number of self-managed funds out there yet to go into the income stream stage you would have seen that the numbers had gone up. Then there is a risk that, as more time goes by, these products may get into difficulty.

Senator SHERRY—On the one hand you are saying, 'The risk is too great because these products are falling over. There's not enough money. In the case of these 12 there wasn't enough asset backing.' On the other hand, we are being told at the other end there is abuse because they have too much in the way of asset backing. You cannot win either way. That is your contention.

Senator CHAPMAN—It is two contradictory positions.

Senator SHERRY—There is a risk at both ends.

Mr Dolan—They are different types of risk.

Senator SHERRY—I accept that, but there is a risk at both ends, isn't there? That is what you are arguing.

Mr Martin—If you look at the certification process, the actuaries are required to certify to a high probability, and that is taken to be 70 per cent.

Senator CHAPMAN—Which is higher than for other forms of pension, isn't it?

Mr Martin—I will come to that. What it means, in effect, if you use that language and use those numbers, is that the actuaries are certifying that there is more or less a 70 per cent probability that there will be some money left over in the fund on death. That is the expectation. But there is up to a 30 per cent probability that you will run out. That is the split: there is a 30 per cent risk of inadequacy and a 70 per cent risk that there will be some sort of effective residual value.

Senator SHERRY—At the end we have just been talking about, approximately 12 have fallen over. Have you actually looked at any of those?

Mr Martin—We have seen all of them, I think.

Senator SHERRY—Have you seen any of them?

Mr Burt—It is very difficult because the information we get is part of the work that we do for FaCS and Centrelink. Sometimes we have reasonable information. I would not say we have good information all the time. Sometimes we have had to surmise what has happened, because effectively the income stream has changed. So we assume that they have run into trouble, but we actually have not got a piece of paper saying, 'We have run into trouble, so we're taking instructions.'

Senator SHERRY—I am just interested to know whether there has been any follow-through with the actuary or the auditor who signed off on these things that have fallen over, if this is potentially such a problem.

Mr Martin—The actuary certifies that there is a good probability that there are sufficient assets, but there is a very significant probability that there are not significant assets. There is no guarantee that the income stream will be able to be maintained.

Senator CHAPMAN—But that is over the full term. We are talking about funds that have only been running for five years. Surely something has gone very wrong in the actuarial declaration.

Mr Martin—Not necessarily. If you see a fund go from $300,000 to $200,000 in 12 months then I do not know that that is the actuarial certification problem; that is just the investment problem.

Senator SHERRY—Isn't that because the tax office has not been doing its job enforcing the investment profile within the DIY fund?

Ms Nicholson—The tax office does not look after prudential requirements. We cannot tell people where to put their money or in what proportions.

Senator SHERRY—You cannot tell them not to put it in jewellery, holiday homes or art collections? I thought that was what you had been doing.

Ms Nicholson—We can tell them what is not allowable, but we cannot say, for example, that certain investments would be good investments. That is not our role. We just regulate. We do not do the prudential role.

ACTING CHAIR—You ensure that there is a reasonable balance in the portfolio, that it is not too skewed.

Ms Nicholson—No, we do not.

Senator SHERRY—You cannot do it under the existing law or you do not do it because you have not started doing it yet?

Ms Nicholson—Our role is regulation only; it is not prudential.

Mr Burt—In fact, if you go back to the previous hearing that we had, quite a few people that were putting submissions in were complaining that this would rule out them putting one whole property as the only investment of the fund. I think if you read through the *Hansard* or the submissions you will find a couple of instances where that was mentioned as the reason why they wanted to do this—they wanted to put one whole property in. If you put all your eggs in one basket, you can occasionally expect nasty things to happen.

ACTING CHAIR—Mr Dolan, how many of these people involved in the 12 funds that ran into solvency problems went on to a full age pension?

Mr Dolan—I do not have that data with me. The data I have has been commenced into a new income stream. One would infer—I do not have any evidence to support it—that it may have provided less income stream than before it was restructured, which means that they may have been, depending on their other situation in terms of assets and income, entitled to a higher age pension, which is a point that Tony Coles made.

Senator SHERRY—No, depending on their other assets.

Mr Dolan—Depending on their other assets—that is right.

Senator SHERRY—If these people have other assets, they have absolutely no drawdown on the age pension whatsoever after those funds fall over. That is quite possible. You go away and look at these 12 and give us the figure for the drawdown on the age pension. Give us the hard data. You know these 12.

Mr Burt—It is unlikely that they will not have any age pension, because by definition they are from our files. Centrelink will not send a case in unless their person is applying for the age pension. So I think you can rule out them not having any age pension at all.

ACTING CHAIR—But it might be quite minimal. That is the point that we are making.

Senator SHERRY—It could be $10. Can you get those figures for us?

Mr Dolan—The assets in question would have been exempt from the assets test. If they were not getting the age pension because of the assets test, that would only be because they had significant other assets apart from an income stream. Of course, then they would not have got a pension in the first place. One would imagine that if they were receiving a pension they might be receiving more pension if their pension was being assessed under the income test because of having less income. That would be the inference.

Senator SHERRY—I accept that, Mr Dolan, but I am just asking you to give us the figure. What has been the growth in the claim of pension entitlements as a consequence of these 12 funds? It helps us to evaluate in our own minds whether this is a significant problem at the moment and the totality of the pension bill that the government pays.

Mr Dolan—I appreciate your question. In terms of the 12, as I said it would be very small and negligible. The risk is the future.

Senator SHERRY—Just get us current figures. We do not want the future figures if you cannot give them to us, if you cannot give us an estimate. Just give us the current figures—what this 12 have been costing the revenue as a consequence of falling over in terms of extra pension payments.

ACTING CHAIR—Can you extrapolate? There is a 50 per cent test now that applies, so these sorts of things are not going to be as popular or as easily accessible as they have been in the past.

Mr Dolan—There is still a significant 50 per cent asset exemption. There is still a significant incentive for people to purchase complying income streams.

Senator SHERRY—But it would seem to me that there are other ways, rather than forcing people out or to have to hook on a retail product. For example, I have had mentioned to me that we could change the asset test treatment. That would be one solution, wouldn't it, Mr Martin?

Mr Martin—I am not sure that anyone is forcing anyone into a retail product.

Senator SHERRY—Yes, they are—come off it. If you put a 50-member for a pension, that will force them into it.

Mr Martin—No.

Senator SHERRY—Put that issue aside. You have a concern—

Mr Martin—It is important to understand what options are available. The market linked pension is available.

Senator SHERRY—We know that, but they do not want a market linked pension. For the people who want a defined benefit pension, the couple of suggestions I have had put to me are that you could change the actuarial parameters in respect of the market linked pension. That is one of a number of options that could be pursued, isn't it?

Mr Martin—A few suggestions have been put in the last week or so. If you like, we can go through some of those. But, to come back to your point, first of all about risk, the simple fact is that the market linked pension and the allocated pension are two products—

Senator SHERRY—I understand that. I did not want to come back to that now. I want to come to the issue of the alternative solutions, other than forcing people out.

Mr Martin—One of the points that was made at the last hearing was that these people are willing to take a lower income stream in the form of a defined benefit pension. An option may well be to take a market linked pension and not consume it all. The question we are really facing here is that it is all very well to say that the people concerned are prepared to take the risk that they will run out of money. The question is whether the government is prepared to confer special tax concessions and social security arrangements on those sorts of arrangements.

Senator SHERRY—Let us deal with the alternative scenarios. I accept that there is a state planning misuse. One of the alternatives that I have had suggested to me—although I would not suggest it myself—is that you could change the tax arrangements for the residue value to the survivors in the trust. If there is a residue left over and there has been RBL compression and tax planning, you could change the tax arrangements, couldn't you? That is one thing you could do.

Mr Coles—Are you suggesting death taxes?

Senator SHERRY—I do not know, but they suggested to me that you could change the tax arrangements within the structure of any residue value if you think that is abuse.

Mr Coles—To address the issue of reserves, I guess one answer is that this is one of the issues that we can consider in more time and detail as part of the review that the government has initiated. So that is part of the issue in the sense that the government has identified that there may be appropriate conceptual frameworks for a small fund paying a pension. These arrangements will be considered from a social security perspective, an insurance perspective and a tax perspective. Death taxes, which I think the person was proposing, are one of those issues. We will consider that issue as appropriate.

Mr Thomas—One concern, too, is the extent to which we might complicate the tax arrangements relating to the superannuation system. It is already fairly complex. If we have a different set of tax treatments for any new elements, that is going to add an additional layer of complexity and cost in the administration of the system.

ACTING CHAIR—Let us go on to some other questions, because we are starting to run short of time.

Senator SHERRY—The RBL formula was the other issue.

ACTING CHAIR—What about compression?

Senator SHERRY—The compression issue.

Mr Thomas—The tax office has some data which indicates the extent to which RBL compression has potentially taken place.

Senator CHAPMAN—'Potentially' or 'has' taken place?

Mr Thomas—Well, Tax talked about—

Senator SHERRY—Has.

ACTING CHAIR—Do we have that data? Senator Chapman has a question on compression.

Mr Hanscombe—Following the hearings in Melbourne, we went back to check the preliminary figures that we gave you at that time. We can now confirm that the numbers of individuals receiving defined benefit pensions out of self-managed superannuation funds over the last 10 years follow the trend that I am about to outline. We can give these figures with much more assurance than we could in Melbourne a few weeks ago. In each year from 1995 to 1998, tens of individuals commenced defined benefit pensions. In 1999, hundreds of individuals commenced defined benefit pensions. In each year from 2000 onwards, thousands of individuals commenced defined benefit pensions. We have now dug below that to find the figures involved. In each year from 1995 to 1998 there were millions of dollars involved; in 1999, tens of millions of dollars involved; in 2000 and 2001, hundreds of millions of dollars involved; and in 2002 and 2003, billions of dollars involved.

Specifically in response to your question, until 1998 the RBL amount reported largely mirrored the dollar figures involved in the pensions. In 1999, this started to change. The RBL amounts reported now—that is in 2003, which is the last year for which we have full figures—are roughly 40 per cent of the dollar values backing the pensions. Of all those pensions, going back over the whole period, almost none of the pensions are excessive, which means that almost none of those individuals exceeded their RBL. I think that answers the question.

Senator SHERRY—If none of them exceeded their RBL, how many do you believe have been dropping their figure below the RBL through RBL compression?

Mr Hanscombe—I do not want to say that it is dropping or whatever, but, using the current formulas in the legislation and the current legitimate arrangements that were there prior to the budget, the total value backing pensions in the most recent year that we have figures, for example, was well over $1 billion. The RBL amount was $557 million.

Senator CHAPMAN—Doesn't that raise the issue that the problem is with the formula?

Mr Hanscombe—That is a policy question.

ACTING CHAIR—But isn't that the first question we should ask ourselves? You say there is a loss.

Senator CHAPMAN—It is a technical question, not a policy question. If the formula is consistently giving a disparity between the actual amount in funds and how that relates to the RBL, that is a technical question.

Mr Coles—In this matter you have to consider what the formula is. It is the annual value times the pension valuation factor minus the undeducted contributions plus any residual capital value. The annual value is subject to some concerns that it can be manipulated, perhaps, to produce a low annual value for the formula so that the amount of assets providing that pension is in excess. That is multiplied by the pension valuation factors which in SIS are based on life expectancy. Important in this is the amount of undeducted contributions. As was presented to me the other day, the wealthier you are the less of a reasonable benefit limit problem you have. The more money you can put into your fund as an undeducted contribution the lower you can bring the assets, the capital value of the product, below the RBL.

I guess in considering each of these elements—and I have excluded the residual capital value because for complying pensions it cannot have one; it must be zero—we need to identify that it can be subject to manipulation at the front end. Pension valuation factors are somewhat dated but there are broader ramifications to fix that for the rest of the community.

Senator SHERRY—Why couldn't you just fix it or change it for the SMSF funds? Why couldn't you just apply a specific formula for these funds? Do you have a legal problem with that?

Mr Coles—Conceptually, we looked at the abuse in relation to these funds. These funds are also conceptually unstable in providing a guaranteed pension. In weighing that up, and to address the arrangement early, the government decided to amend the law to fix the abuse—the fact that non arms-length arrangements were being used inappropriately.

Senator SHERRY—That does not answer my question. Is there any legal problem in applying a specific formula to these funds or changing the specific formula that applies?

Mr Martin—You would still be left with a lack of certainty.

Senator SHERRY—I am not dealing with a lack of certainty. I am dealing here with the issue of the RBL compression. If you have a problem with RBL compression surely it is legal to change the formula that applies to these funds?

Mr Martin—And what are you going to do about reserves?

Mr Coles—We can pretty much amend the law to say anything.

Mr Thomas—The question is: would that address the whole problem? It would not, on its own.

Senator SHERRY—I am looking at this issue at the moment. I am sure there are other issues—

Mr Thomas—That is one particular aspect but there are a multitude of aspects.

Senator CHAPMAN—In introducing these regulations you do not deal with the RBL compression problem. Because the RBL compression problem remains if you purchase a pension from a life office you can get away with your RBL compression.

Mr Coles—That is so, essentially, Senator, but the person is going to have to give up their capital. In most of these arrangements you give up capital.

Senator CHAPMAN—You give it up to the life office.

Mr Coles—You give it up to provide certainty and to provide a pension.

Senator CHAPMAN—The figures that I have show that more of it will finish up with the life office than with a self-managed fund.

Mr Coles—But in providing that certainty you have a third party to ensure that there is an appropriate pension to be paid for the life of that pension.

Senator SHERRY—And you have to pay them for it in addition to the existing costs in DIY.

Mr Coles—In relation to a complying fund paid from a self-managed fund or a small fund there will always be a drawdown of capital so there is going to be zero at the end. So it is not conceptually correct to suggest that there is some sort of magic pudding in relation to this.

Senator SHERRY—We are not suggesting a magic pudding.

Senator CHAPMAN—I can give you two quotes here that have been given to me from two life offices where the defined benefit pension per annum would be significantly below the annual earning rate of the fund.

Mr Coles—I cannot answer that. That is based on two quotes, and who knows what the design of the pension is.

Senator CHAPMAN—I can give you those details if you want them. In both cases, that defined benefit pension was less than half the pension that was signed off by the actuary of the self-managed fund as appropriate for that fund if it had been provided through the self-managed fund.

Mr Coles—To counter that argument, I can draw on my understanding of the advice of the Department of Family and Community Services that some of the pensions they were seeing were less than what could be obtained from a large provider. So it depends on the circumstances, the design of the pension, the quality—

Senator CHAPMAN—These are actual quotes obtained from life offices.

Mr Coles—Yes, but so are the examples provided elsewhere. A pension paid from a small fund can be less than that provided from a life company on a similar basis for a similar amount of money, except that the life offices can guarantee that the pension is going to be paid.

Senator CHAPMAN—And retain the balance.

Mr Coles—There will be some money to the shareholders who are taking the risk to provide that guarantee. I think that is appropriate.

Senator SHERRY—Well, if you have seen that, give us the examples, please. I would be interested to see them. You do not have to do it now; if you have got it now, fine.

Mr Burt—You want examples of—

Senator SHERRY—Real life examples of a life company giving more.

Mr Burt—Okay. This is an extreme example, but you asked for an example. We have an example of a 16-year term pension, no indexation. The purchase amount was $40,000. The annual pension amount is $2,500. I will let you work out what 16 times 2,500 is.

Senator CHAPMAN—Who is providing that pension?

Mr Burt—That was an SMSF. That is clearly a case where I would struggle to believe that a life office could not provide a better pension than the $2,500 in that example.

Senator SHERRY—What would the going rate be?

Mr Burt—I do not know because I have not actually done the calculations, but I would—

Senator SHERRY—How can you struggle to believe if you do not know what the going rate is?

Mr Burt—Sixteen times 2,500 equals 40,000. I could put the money in a bank account and do better than that.

Senator SHERRY—But what is the going rate from a typical life company at the moment?

Mr Burt—Okay. I am going to be extremely conservative.

Mr Coles—It is going to depend on your benefit structure, Senator.

Senator SHERRY—I understand that. You raised this issue of real life examples, that you knew of cases where someone in an SMSF—

Mr Burt—No, I actually said that from my understanding of DFaCS's evidence—

Senator SHERRY—Okay, but we have not got the evidence yet. We have got an assertion or a claim; we want the evidence. Give us some real, hard cases. I would also be interested to know what their fees are in both cases.

Mr Burt—I will give another example. This one you can actually cross-check, because it is in somebody else's submission, or something similar to it is in somebody else's submission. This is a male, 65; reversion to a female, 64. Purchase price: $207,000. Annual pension: $7,700, with zero per cent indexation. We have assessed that if you went along to a life office that would cost you about $100,000. If you read Mr Truslove's paper, he says that he would expect a nil indexation annuity for $100,000 to produce an income of about $8,100. So we are talking about twice the purchase price and a smaller annuity.

Senator SHERRY—You are running a pretty good argument against choice here, from the look of it.

Mr Burt—Exactly.

Senator SHERRY—Thanks, Mr Burt! I will use that in other contexts.

Mr Burt—Hold on—this is the pension from an SMSF.

Senator CHAPMAN—Can I give you my example and you might care to comment on it.

Mr Burt—Yes, by all means.

Senator CHAPMAN—This is an actual example. A male aged 57; a female spouse, aged 44. Initial capital: $1.4 million. Life expectancy of the 57-year-old male: 24.2 years. The actuarial certification of the pension from the SMSF would involve an expected payment period of 24 years. The actuarial certification was for an initial pension of $70,000 per annum, CPI indexed. The two quotes for a CPI indexed pension obtained from major life offices were, in one case, $21,000 per annum, and in the second, $34,000 per annum, which would be less than the earning rate of the fund.

Mr Burt—Could I clarify the terms of the pension here. You said a 57-year-old male and a 44-year-old female. Is this payable for life or payable for 24 years?

Senator CHAPMAN—It is payable for life but with an expected payment of 24 years, given the life expectancy.

Mr Burt—I think you would expect this to be payable for closer to 45 years rather than 24.

Senator CHAPMAN—I said this 57-year-old male has a 24.2 year life expectancy.

Mr Burt—Would there be 100 per cent reversion to the female?

Senator CHAPMAN—Yes, I think so.

Mr Burt—You would expect that to be payable for more like 45 years, possibly 50 years. It is the reversion that hurts with this one.

Mr Coles—That is part of the issue: we can pick and choose different—

Senator CHAPMAN—If that is the case, it is still a substantial difference between what the actuary certified and what the—

Mr Martin—I am not sure that that sounds like apples and apples; it may have been a miscommunication.

Mr Burt—These are very back-of-the-envelope calculations. For that pension to be delivered, the fund has to earn five per cent real—that is, real relative to CPI—after expenses. That is roughly what you have to do to deliver the $70,000 pension. So if you believe that the fund can probably earn about six per cent above CPI over 50 years then this is viable.

Senator CHAPMAN—Your normal earning rate would be about five per cent?

Mr Burt—With 100 per cent equities, long term, you might get somewhere between four and seven per cent over 50 years, but with an awful lot of volatility. It has to be the right 50 years. If you started in 1929 before the crash—

Senator CHAPMAN—Even if you get four per cent on $1.4 million that is getting up towards about $55,000 a year without drawing on capital at all.

Mr Burt—You are saying $70,000, so you are having to start drawing on capital, even at that level.

Senator CHAPMAN—No, that is at four per cent. The years that you get seven per cent, you are going to have $90,000.

Mr Burt—If you can guarantee me seven per cent real, Senator, I am going to invest with you.

Senator CHAPMAN—That is not what I am saying. You said that you would get between four and seven per cent, so some years you are going to get four, some years you are going to get five, some years you are going to get six and some years you are going to get seven. But, if you work on five per cent—

Mr Burt—But that is going well basically.

Mr Martin—Going well and getting the right 50 years et cetera. What it sort of does is point you to the difference between an actuarial sign-off for an SMSF and the level of guarantee that a commercial company will give.

Senator CHAPMAN—At $21,000 and $34,000 per annum they are not even going to be using the annual—

Mr Martin—As I said, there may well be some apples and oranges in that comparison. One of them sounds like it is genuinely payable for life with 100 per cent reversion and the other one may not be.

Senator CHAPMAN—Even if you assume the life office one is payable with 100 per cent reversion and the SMSF one is not, they are paying well below the annual earning rate of the fund. They are not even going to go near touching the reserves.

Mr Martin—We would have to have a look at it.

Senator CHAPMAN—So there is a big lump left there for the life office at the end of it.

Mr Martin—Potentially there is also a lot of risk there. If you look at the Japanese life companies, they are in trouble because they are struggling to earn two per cent and they have written business assuming that they will earn four or five per cent. So you cannot take anything for granted.

Senator CHAPMAN—No, I know you cannot, but there is a pretty big safety margin built in there.

Mr Martin—Possibly.

Senator CHAPMAN—They are offering less than two per cent. There are offering $21,000 on $1.4 million. What is that? It is well under two per cent.

Mr Martin—The best thing to do would be to put the $1.4 million into a market linked pension and see if you can get five or seven per cent real or whatever it is and, if you do, there is no problem and it works out well. If you do not—

ACTING CHAIR—Could we get back to the compression rates because we are running out of time.

Senator SHERRY—I had an issue about the 50, but I have no questions on compression.

ACTING CHAIR—If there are no more questions on compression, what is the next topic that you want to debate with Treasury?

Senator SHERRY—I have one final issue, given the time. Have there been any projections, estimates or examination of what the behavioural change will be given the minimum 50-member requirement? How many people in an SMSF or a DIY are likely to actually purchase a pension from a life company, given that requirement?

Mr Coles—We have not projected that information.

Senator SHERRY—Is it less likely that they will do it?

Mr Coles—My expectation is that they will be looking to provide a pension through the market linked income stream or that they will take a pension. At the moment they can continue to take a pension so there is not going to be that much difference in the future.

Senator SHERRY—Is it not much more likely that they will go into a growth pension?

Mr Martin—In combination with an allocated pension, that could be right. In which case, you are in products which your SMSF can deliver without risk.

Senator SHERRY—What do you mean by 'without risk'?

Mr Martin—There is no risk that the SMSF cannot deliver a market linked pension or an allocated annuity on the terms set down. There is a significant risk that a SMSF cannot deliver a guaranteed lifetime pension.

ACTING CHAIR—What about the 50-member rule? Are there any questions on that?

Senator CHAPMAN—How does imposing a 50-member rule on a fund paying lump-sum defined benefits make it any more secure or sustainable than a fund with only five members? There are not any longevity risks and the investment risks can be managed through an investment policy in exactly the same way that a large fund manages its investment risk.

Ms Lejins—The 50-member defined benefit threshold is based on advice from the Australian Government Actuary on the minimum acceptable pooling base required to satisfactorily pool investment and mortality risk of paying a defined benefit. The threshold also ensures the trustee and members of the fund are at arm's length. The 50-member threshold is used for the purposes of applying the equal representation rules under the Superannuation (Industry Supervision) Act. A 50-member approach is likely to limit arrangements to genuine ones. Both the Australian Prudential Regulation Authority and the Australian Taxation Office may exempt funds from the 50-member rule in circumstances where there are adequate arrangements in place to fund future pension benefits and the trustee and members of the fund are at arm's length.

Senator SHERRY—Where does the Actuary get the 50 from?

Mr Martin—There is nothing magic about 50. Things are not all doom and gloom at 49 and then fantastic at 51. If you are looking at pooling risk, then the more members the better the level of pooling.

Senator SHERRY—But where do you get the 50? Is there an international precedent? Do you sit down and draw a number out of the Lotto hat?

Mr Martin—It was just mentioned that the number 50 is used elsewhere in SIS. In fact you can, for pension benefits, get some quite good stability from 50. Let me give you a quick example. A fund paying a pension to a male aged 70 will ask itself what its cash requirements are going to be in 10 years time—that is, for one male aged 70. The answer is that it will be paying either zero pensions in 10 years time or one. There is a good chance that it will be paying one, but there is a good chance that it will be paying zero. It cannot predict confidently what level of pensions will be payable in 10 years time—it is going to be nought or one. But if a fund with 50 members is asked the same question it can predict confidently that in 10 years time it will be paying between 30 and 40. So it can get a good feel for its cash flow.

Senator SHERRY—So this is your judgment?

Mr Martin—This is based on population mortality.

Senator SHERRY—It is still your judgment. Where did this figure of 50 come from? Can you say that you have weighed up the evidence and looked at approximately what it is?

Mr Martin—I have pointed out that it is not a magic number.

Senator SHERRY—I accept that.

Mr Martin—It is not that 49 is bad and 51 is good.

Senator SHERRY—Who came up with the number of 50?

Mr Martin—It is a practical number.

Senator SHERRY—Who came up with it?

Mr Coles—It is a number that already exists. Essentially it is in the arms-length equal member representation rules, where if you have 50 members in a fund you have got to have equal rep or you have got to have an independent trustee. That provides some certainty that inappropriate arrangements will not take place. The 50-member rule is a base minimum that we were working from.

Mr Thomas—It is a matter of judgment.

Senator SHERRY—I accept that. I am just interested as to how this judgment was reached and why it is 50.

Mr Thomas—Essentially there was an existing precedent for 50 to be used.

Senator SHERRY—In a different context.

Mr Thomas—In a different context, certainly, but there is less confusion if it is linked to something that is already known to people in SIS. Fifty provided a reasonable pooling system, which, as Mr Martin has said, gives some degree of comfort. Obviously we could have gone for a higher number—200 or something like that—which is also mentioned in SIS, but that is substantially higher and the government was not convinced that it was justified to go to that level.

Senator CHAPMAN—The fund does not have to have 50 defined benefit members, does it? As we discussed at the previous hearing, it could be 49 accumulation members and one defined benefit member, or 48 and two.

Ms Lejins—If it is a fund that is actually paying a defined benefit, it must have 50 defined benefit members. If, however, it is paying a defined pension, it may have 49 accumulation members and one pensioner member. Importantly, the 50-member threshold for a fund paying a defined benefit pension may provide for somewhat less pooling. However, it does provide a practical implementation mechanism. Importantly, it does ensure that the trustees and members of the fund are at arm's length and that these arrangements are genuine.

Senator CHAPMAN—But the accumulation members would have their assets segregated, wouldn't they?

Ms Lejins—It would depend on how the fund is actually structured.

Senator SHERRY—The theory is that the trustees are at arm's length. The practice might be a bit different in some cases. That is the theory, isn't it, for the trustees? There is a greater chance that they will be at arm's length.

Ms Lejins—Yes. We have equal representation or an independent trustee. Even the quantum of 50 obviously is going to make it extremely difficult for the arrangement not to be at arm's length.

Senator CHAPMAN—Mr Burt, I recall that when we were discussing this issue before you used the example of the stock market dropping by 90 per cent and the fund winding up. You contended that the pensioner was better off by being part of the larger group because the loss was shared. In fact, particularly with segregated assets, hasn't everyone lost 90 per cent?

Mr Burt—Yes. I think I actually said—and I have not checked *Hansard*—that I had not explained it very well the previous time. The reason for the fallout that I was trying to explain, although I did not explain it very well, was that if the pensioner lived longer than expected then effectively the loss was shared amongst all the members rather than the pensioner effectively running out of money.

Senator CHAPMAN—Would it be if you have got segregated assets?

Mr Burt—It depends on the terms of the trust deed. I at least remembered to say that the previous time. It does really depend on the terms of the trust deed. But, assuming that gains and losses are spread amongst all the members, if you have a pensioner that lives 10 years longer than expected, all the members suffer a little bit rather than the pensioner suddenly running out of money.

Senator CHAPMAN—That is not a requirement of the regulations, is it?

Mr Burt—It is not a requirement of the regulations. As Treasury have mentioned, it is a compromise.

Mr Martin—It is true to say that, if you have 49 accumulation members and one defined benefit member, the extent of pooling is significantly less. It is not zero; there is some spreading of risk with accumulation members, or some diminution of risk, because, for one thing, you have a better feel for your cash flow

requirements and what your cash flow is going to be. But you move from that to asking what is a practical implementation mechanism, and it is easier to count the members than it is to do anything else.

Senator CHAPMAN—I would like to go back to the funds that have supposedly fallen over. Have those 12 funds just been restructured or have they completely fallen over?

Mr Dolan—The only information I have is that they were commuted and rolled over into a new income stream, so they continued as an income stream but obviously under different terms and conditions. Does that answer your question?

Senator CHAPMAN—Could that in part or in total be due to the changes to the SI(S) regulations that require a higher level of guarantee?

Mr Dolan—I can add some further information. After the rollover the reductions in income stream payments were as much as 20 per cent lower than they were before the commutation occurred. So there were reductions in the incomes that were received by those funds.

Senator CHAPMAN—My question is: could that have been due to the change in requirements for actuarial certification from reasonable probability to higher probability?

Mr Burt—No, they are not high-probability restructures.

Senator CHAPMAN—In relation to risk, why are you saying that the only acceptable way of managing risk is, in effect, to have retail institutions manage it?

Mr Martin—It is a question of what sorts of arrangements are acceptable to the government for the special tax and social security benefits that are conferred on the superannuation system. The products that are now allowed—allocated pensions and market linked pensions—are risk free in that sense. The notion of providing a defined pension from a small fund, if you use the actuaries' own sign-off, is that in effect they are certifying that there is up to a 30 per cent probability that it is not capable of being delivered, which is a significantly higher risk than a life office would deliver.

Senator CHAPMAN—Given the problems, particularly in the UK, that were experienced with Equitable Life and also AMP subsidiaries in terms of defined benefit pensions, there is still a significant degree of risk there is well, isn't there?

Mr Martin—You would have to say that the risk is very small compared with the risk presented by an SMSF, notwithstanding all of that. We have got a comprehensive prudential framework in place.

Senator CHAPMAN—Have you done any work on the comparable risk between an SMSF fund failing and a retail fund failing in terms of its impact on government revenue and access to pensions and so on?

Mr Coles—No, essentially the prudential rules in relation to life companies are quite stringent and strict in that they are required to require sufficient reserves to manage the—

ACTING CHAIR (Senator Stephens)—I am sorry, that is a division so we will have to suspend proceedings briefly.

Proceedings suspended from 6.05 p.m. to 6.15 p.m.

ACTING CHAIR—We will resume the hearing.

Senator CHAPMAN—The other issue that was raised in our previous hearing was that of estate planning in relation to assets being left over on death being payable to a beneficiary. At the previous hearing Ms Lejins said:

> A payment of a death benefit ETP lump sum is tax free to a dependant up to the deceased's reported RBLs, so it is not taxed.

But anything over the RBL is taxed at 38 per cent. That is correct, isn't it?

Mr Coles—In relation to a pension?

Senator CHAPMAN—A lump sum.

Mr Coles—If it is a lump sum, it will be taxed at 47c. In relation to a pension—

ACTING CHAIR—Those are the division bells ringing. We will press on.

Senator CHAPMAN—Sorry about that, Mr Coles. So you were saying it was for a lump sum, as against a pension?

Mr Coles—That is correct. Where it is a pension, the pension will be continued if it is paid to a dependant. If a deceased dies in the pension phase and a lump sum is paid, it is a death benefit ETP. The ETP is only excessive to the extent that the pension was excessive. Let us get technical. If the pension was not excessive prior to it under the relevant rules, then it is not excessive.

Senator CHAPMAN—If it was under the RBL?

Mr Coles—Yes. If it is under the RBL, it is not reassessed. If the pension is paid, there is no RBL reassessment. The deductible amount and pension rebate will continue to apply to the income stream.

Senator CHAPMAN—But your real concern was the lump sum payments, not the pensions, because the pensions would only go to a dependant anyway, wouldn't they? They would only go to a surviving spouse or a dependant child. The real issue is the lump sum, isn't it? Isn't this what you have been talking about—this accumulation of lump sums left at the end?

Mr Martin—It is about accumulating that amount in the concessional environment for a long period of time. It is the flip side of the risk of the thing falling over. There is the risk associated with excessive accumulation.

Mr Thomas—In fact, the cameos that we supplied to the committee on Friday night highlight the effect of the lower income streams from lifetime pensions versus market linked allocated ones and how that results in a build-up of assets in the fund over the life of the pension. For example, after 20 years with a $600,000 initial income stream, the balance in the fund after 20 years of pension payments has a figure of $803,000 for the lifetime pension, $453,000 for the market linked one and $317,000 for the allocated pension. So there is a significantly greater amount remaining after 20 years, and that continues to be the case with much more significant proportional amounts once you get past the age of 85. At the age of 90 the difference is $816,000 for the lifetime pension versus $282,000 for the market linked one and $191,000 for the allocated pension. That is at the $600,000 purchase price. If you look at the other cameo that we provided of a $5 million initial income stream, at the age of 85 the amount remaining in the lifetime pension was $6.7 million, in the market linked one it was $3.8 million and in the allocated pension it was $2.6 million. At the age of 90 it increases further in the lifetime to $6.8 million, whereas the other two have declined substantially.

Senator SHERRY—But, in the case of the market linked and the allocated pension, when the person dies the residue is passed on to the estate without tax, isn't it?

Mr Thomas—Yes.

Senator SHERRY—It is a higher figure according to your estimates with respect to the lifetime pension that remains in the trust and is taxed at the concessional rate.

Mr Martin—That is because of the need to set up reserves.

Senator SHERRY—Yes.

Mr Thomas—So the effect of the reserves and the relatively low initial income stream that it is set at result in that accumulation of assets in the fund over time.

Mr Martin—So that describes part of the risk. If you are talking about risk, the income tax paid is less on the defined benefit pension because the income is lower, and the age pension that is associated with the defined pension tends to be higher, again because the assessable income is lower.

Senator SHERRY—But again, you could change the actuarial parameters for the calculation of a lifetime pension, couldn't you? Then you presumably would expose yourself to a greater risk of failure.

Mr Martin—That is right. I think Mr Burt made the point on 26 July that you cannot do all three things—you cannot guarantee an adequate level for life.

Senator CHAPMAN—I note your comment that in each case the balance remaining in the fund at death is available for payment to dependants tax free or to the estate, and how the estate distributes the death benefits will determine the tax outcomes. But if you are talking about someone at age 90 or 95 there are not likely to be dependants receiving anything tax free, are there? Unless they are Abraham!

Mr Burt—Any child counts as a dependant for tax purposes, doesn't it?

Senator CHAPMAN—No.

Mr Coles—No.

Senator CHAPMAN—They have to be a dependent child.

Mr Coles—Essentially, a dependant for SIS, for superannuation purposes, will include any child. For tax purposes, a dependant can include an adult child—under the government's new rules under the interdependent relationships legislation—where the son, for example, has been looking after the parent. So they can get the benefits tax free as well, under these rules. Alternatively, if they are not financially dependent or they are living separately, they will still receive concessional tax treatment for the benefit. It would not be tax free as such but it would be taxed on that higher rate. Nothing is easy in tax!

Senator CHAPMAN—No. But again, this all really revolves around the RBL, doesn't it? That is the real issue.

Mr Coles—Yes and no. There is interconnectedness. That is part of the issue. At one level, there can be concerns for people paying a pension—that they are going to receive that pension. I do not see it as just one product; it is a spectrum of issues. At the other end of the spectrum, to provide that certainty they have to have reserves. Those reserves can be passed onto the kids or to whoever under the rules of the fund, and those reserves can be a form of inappropriate estate planning.

Senator CHAPMAN—Given the small percentage who might be dependants and receive it tax free, the balance—

Mr Coles—It also depends on how the rules are structured.

Mr Martin—They still accumulate it in a—

Senator CHAPMAN—The balance would pay—what—38 per cent?

Ms Lejins—Fifteen per cent is the tax rate for a lump sum benefit paid to a non-dependant up to the reported RBL.

Senator CHAPMAN—I am talking about in excess of the RBL.

Mr Coles—But if it has been previously assessed, and depending on the fund—for example, if it has been assessed as being below the RBL, benefits passed on will be considered below the RBL—

Senator CHAPMAN—That is an issue you can address through the RBL formula.

Mr Coles—No, it is not through the formula; it is actually through other parts of the tax act. That is part of the interconnectedness of this, in that there is a whole ripple effect. If you start playing around with the formula, then there is going to be a ripple effect throughout the whole treatment of the RBL system. For example, if you just play with pension evaluation factors, you are actually going to be playing around with the income streams that public servants receive, the income streams provided by large corporates, such as old BHP funds—the benefits that they are going to receive in their retirement. If you try and fiddle around with the residual capital values then that also has impacts on other parts of the tax act.

Senator SHERRY—If you apply it to the entire system, you can narrow it down to these products, can't you?

Mr Coles—That is exactly what the government has done. It says that because of the general concerns about the insurance product—

Senator SHERRY—In a different way.

Mr Coles—In a different way, but it has been done.

Senator CHAPMAN—It has done it with a sledgehammer rather than a scalpel.

Mr Coles—That is hard for me to comment on.

Senator SHERRY—I just want to get this clear. There is a residue value under all three options—allocated, market linked and lifetime. What you are saying is that the level under market linked is higher, on average, presumably.

Mr Martin—Under the defined pension, under lifetime.

Senator SHERRY—It is higher.

Mr Martin—It is expected to be higher.

Senator SHERRY—Do we know how many people have used RBL compression?

Mr Martin—The tax office gave you those numbers.

Senator SHERRY—What is the estimate?

Mr Hanscombe—We have given you the total figures.

Senator SHERRY—Yes, but you did not give us the number of persons.

Mr Hanscombe—What we gave you was thousands of people each year in the last three years.

Senator SHERRY—That is what I wanted to clarify. Are you saying that the thousands of people have used RBL compression and unfairly taken advantage of the rules to get below?

Mr Hanscombe—We are not making any comment about whether or not it is fair. The rules that were in existence at the time allowed them to do that.

Senator SHERRY—But have thousands of people used RBL compression?

Ms Nicholson—From the numbers we cannot tell you exactly how many. The way they pan out from 2000 onwards shows that the RBL amount is 40 per cent of the total assets backing those pensions. So we would assume that large numbers have used RBL compression.

Senator SHERRY—Because of the 40 per cent figure you are assuming that there are some well over RBL.

Ms Nicholson—There are some who should be but they have obviously compressed.

Mr Thomas—The excess amount is quite low, isn't it, if it is reported to the tax office?

Mr Hanscombe—Just for example, the figure I gave you earlier for 2003 shows that there is well over $1 billion involved in these pensions. Of that $1 billion, only a little over $13 million was excessive. It is not surprising. The formula is there. They understand exactly how much to put in.

Mr Thomas—That is what? About one per cent?

Mr Hanscombe—Roughly, yes.

Senator SHERRY—Could that not indicate a growth in superannuation as well? Need it necessarily indicate a significant growth in RBL compression?

Mr Hanscombe—In a situation where you find yourself with X dollars in superannuation, the financial planner or actuary or whoever just tells you how many dollars you need to put in to bring it down below your RBL.

Senator CHAPMAN—What is the problem with determining the RBL on the basis of a tax dollar of contribution?

Mr Coles—It does not resolve all the issues. I keep coming back to the fact that it is a multitude of issues.

Senator CHAPMAN—But does it need to be?

Mr Thomas—Well, it is.

Mr Coles—It is. That is the concept. That is how our superannuation system has evolved. We have a very complex system; it is all interconnected and interwoven. The way the government addressed this issue was to say that here was a certain segment of inappropriate activity that would probably have captured some appropriate arrangements as well. But the nature of the arrangement was that if it continued to expand and go forth it would challenge the integrity of the retirement income system. So the government excised that part of it and addressed the core concerns. The government has subsequently said, to address the concerns of people who might have been inappropriately affected by those legitimate arrangements, that it will conduct a review to work out how we can ameliorate these ripple effects. This will ensure the development, if at all possible, of a retirement income product that provides certainty of income over a certainty of lifetime, that does not mean tax avoidance or inappropriate estate planning and that provides security at retirement.

Senator CHAPMAN—If, for instance, you remove the capacity of the additional after-tax contributions to have this compressing effect, what other difficulty would that create for public service superannuation or other areas?

Mr Hanscombe—From a regulator's point of view, there are a lot of different ways you can approach it but I understand the government has announced a massive review of it. It would not be a simple thing to do what you are suggesting. I agree it is a possible way to go but it would not be simple to do.

Senator CHAPMAN—We need to find a way of getting rid of any areas of abuse without preventing self-managed funds paying defined benefit pensions.

Mr Coles—We need appropriate arrangements. We agree, Senator.

Mr Martin—We did some modelling on the effect of aligning the lifetime pension RBL test with the market linked RBL test in terms of its impact on tax collections. About 35 per cent more tax would be payable under the lifetime pension if the RBL test were aligned with the market linked pension RBL test.

Senator CHAPMAN—Is that 35 per cent more than they pay now or 35 per cent more than the market linked pension?

Mr Martin—That is 35 per cent more than they pay currently.

Senator SHERRY—In rough figures what would that be?

Mr Martin—This is based on the cameos that you have.

Senator SHERRY—The cameos from today or the cameos from Friday, a week ago?

Mr Martin—From Friday.

Senator CHAPMAN—Is that because more of the funds would be in excess of their RBL?

Mr Martin—That is right. So there would be a smaller rebate payable on the pension. However, if you did that, the market linked pension would still deliver about 70 per cent more income tax than the revamped lifetime pension.

Senator CHAPMAN—At the hearings we had a couple of weeks ago was the first time I became aware that any after-tax contributions had an effect on your tax contributions in terms of the RBL. My assumption was that you had tax contributions which went up to the RBL and you could add after-tax contributions to that. When you drew your pension down you would get a rebate on your taxed contributions but you would not pay any tax on your after-tax contributions. You are saying that one affects the other.

Mr Martin—Yes.

Senator CHAPMAN—Is it possible to break that link?

Mr Thomas—Not without a significant flow-through effect on the system.

Mr Burt—I believe the system was designed to cater for what I call the ‘traditional defined benefit funds’—those that were run by big corporations and government. Quite often those are structured so that they provide a pension and an element of that is contributed by the members. For simplicity it was decided to value the pension then knock off the undeducted member contributions. So the way it was designed probably worked well for the traditional defined benefit funds but the market has moved on and people are saying, ‘Here are the rules; how do we exploit them?’ That is what has happened.

Senator CHAPMAN—We need to try and get to a position where those rules cannot be exploited, without killing the whole thing.

ACTING CHAIR—Thank you very much, ladies and gentlemen, for your appearance here this evening. That concludes this inquiry.

Committee adjourned at 6.34 p.m.