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14 July 2004

Dr Sarah Bachelard
Secretary
Senate Economics Committee
Parliament House
CANBERRA ACT 2600

Dear Dr Bachelard,

RE: INQUIRY INTO *SUPERANNUATION INDUSTRY (SUPERVISION) AMENDMENT REGULATIONS 2004 (NO. 2)*

We are writing in relation to the Senate Economics Committee's inquiry into the above amending regulations.

Our submission deals with one issue, only – which self-managed superannuation funds, in existence at 11 May 2004, qualify for the defined benefit pension "grandfathering" arrangements. We believe that the interpretation given in the Explanatory Statement to these Regulations, as confirmed in the Commissioner of Taxation's draft superannuation determination on this issue (*SD 2004/D1*), will lead to unnecessarily harsh and unintended consequences for the foreseeable future.

The Committee has received a number of submissions which deal with the inequity and unintended consequences of the other aspects of this Instrument. In the main, we support those submissions - if there is a perceived problem with the way in which the reasonable benefits limits or estate planning laws operate when SMSF's provide defined benefit pensions, perhaps the problem is with those laws, rather than with the fact that SMSF's provide these pensions in the first place.

The Explanatory Statement

Our submission relates to the interpretation, contained in the Explanatory Statement to *Superannuation Industry (Supervision) Amendment Regulations 2004 (No.2)*, of the wording which a SMSF must have had in its governing rules on Budget night in order to access the grandfathering arrangements. To quote from the Explanatory Statement:-

> "The new division will not prevent a defined benefit pension from being paid by an existing superannuation fund **where the governing rules of that fund set out the terms and conditions of the pension prior to the commencement of these regulations**. If, however, the governing rules of an existing superannuation fund are amended to specify a term or condition of the pension, prior to the commencement of that pension, then the new division would apply." [emphasis added]

Someone reading the above excerpt from the Explanatory Statement might believe that the amending regulations actually contained a provision specifically preventing a fund from paying a defined benefit pension, unless its governing rules contained the "terms and conditions" of the pension, prior to 12 May 2004. In fact, the amending regulations contained nothing of the sort.

What the Regulation Actually Says

The primary regulation dealing with the grandfathering arrangements for defined benefit pensions inserts a new Regulation 9.04F into the *Superannuation Industry (Supervision) Regulations 1994*. Relevantly, sub-regulation (1) defines the scope of the prohibition on SMSF's providing such pensions as follows:-

> "This Division applies to:
>
> (a) a regulated superannuation fund established after the commencement of this Division, the governing rules of which provide for the payment of a defined benefit pension; and
>
> (b) a regulated superannuation fund established **before** the commencement of this Division, **the governing rules of which are amended after the commencement of this Division to provide for the payment of** a defined benefit pension." [emphasis added]

Certainly, this sub-regulation does not mention anything about the governing rules of a pre-12 May 2004 SMSF needing to contain the "terms and conditions" of a defined benefit pension, in order for it to be able to pay defined benefit pensions. It merely says that a fund cannot amend its governing rules after the commencement of the amendments to "provide for the payment of a defined benefit pension".

The Common Drafting Approach in Superannuation Fund Deeds

Now, the vast majority of superannuation fund trust deeds do not list out in detail the minimum terms and conditions for each type of pension (allocated, lifetime, life expectancy, etc.) specified by the *SIS Regulations* (See Regulation 1.06 for the complete list). There are two reasons for this.

First, these conditions run for about seven (7) pages, so including them in full in a deed was always thought to unnecessarily add to the length of a document which must already encompass a large volume of legislative proscriptions (not to mention the unwritten law applying to trusts).

Second, Parliament is apt to change these terms and conditions on at least an annual and sometimes a seasonal basis. So, for example, Parliament has amended these provisions seven times in the past seven years: SR No. 309 of 1997; SR No. 193 of 1998; SR No. 312 of 1998; SR No. 239 of 1999; SR No. 353 of 2002; SR No. 171 of 2003; SR No. 148 of 2004.

As a result of the frequency of these changes, most deed drafters will normally use words such as, "the fund's trustees may pay any type of pension allowable under the *SIS Regulations* to a member, subject to that pension at least meeting the minimum standards specified in the *Regulations* for the type of pension being paid".

If one had read the new Regulation 9.04F prior to reading the Explanatory Statement, one could be forgiven for believing that the inclusion of such a clause in a trust deed met the requirement for a fund's governing rules to "provide for" the payment of defined benefit pensions prior to 12 May 2004. According to the Explanatory Statement, however, the fund's deed must contain much more to qualify.

Where Does the "Terms and Conditions" Argument Come From?

In order to understand the "terms and conditions" proposition in the Explanatory Statement one must refer to the definition of "governing rules" from Section 10(1) of the *SIS Act*:-

> "**governing rules**, in relation to a fund, scheme or trust, means:
>
> (a) any rules contained in a trust instrument, other document or legislation, or combination of them; or
>
> (b) any unwritten rules;
>
> governing the establishment or operation of the fund, scheme or trust."

Most professionals would consider that the words "unwritten rules" in this definition are similar in meaning to the shorthand employed by judges and commentators for centuries, when referring to the common law, equity, natural justice and other case-based laws as the "unwritten law" (cf. statute-based law) and the word "document" to something which evinces an awareness and intention by the trustees to actually change the rules governing the fund..

However, according to the Commissioner's draft superannuation determination, *SD 2004/D1* (acting in his capacity as SMSF Regulator, not as Commissioner of Taxation):-

> "If a document or unwritten rule of a regulated superannuation fund is amended, or a new document or unwritten rule is created, on or after 12 May 2004 to provide for payment of a defined benefit pension, Division 9.2B applies. This includes but is not limited to changes to the fund's trust deed and may therefore also include a resolution as to the terms and conditions on which a defined benefit pension is to be provided… The governing rules may include a broad provision to the effect that the fund may pay a pension, without specifying the terms and conditions under which the pension may be paid. In that case, having regard to the Explanatory Statement, it is considered that, **if a resolution establishing the terms and conditions on which a defined benefit pension is to be paid is made on or after 12 May 2004, the governing rules of the fund are amended** to provide for the payment of a defined benefit fund in terms of paragraph (b) of subregulation 9.04F(1). Payment of the pension would be prohibited." [emphasis added]

We find this to be quite an astonishing proposition. In effect, the argument is that a superannuation fund's trustees can not only completely ignore the provisions of the deed which specify how an amendment to the rules is to be made (and who else, such as the members, must approve it), but that the trustees can amend the rules *without even being aware that they are doing so*.

Oops, We Just Amended the Governing Rules…or Did We?

Trustees hold meetings and pass resolutions all the time. The interpretation being promoted by the Explanatory Statement and draft determination raises the question, how many of these resolutions will constitute an amendment to the governing rules? How do the trustees decide which resolutions they pass are simply resolutions and which ones are rule amendments?

To provide a couple of examples, Section 52(2)(f) of the *SIS Act* requires that a superannuation fund's governing rules contain a covenant to develop an investment strategy. In most cases, the deed does not contain the details of the strategy, only the general obligation to formulate one. The fund's trustees will develop and document the strategy, then table it before a meeting for approval and adoption. Does resolving to adopt this strategy result in it forming a part of the governing rules of the fund? What about a resolution to appoint an auditor of the fund – does the auditor's name now form part of the governing rules? Similar questions arise in relation to other resolutions – resolving to accept the financial statements each year; to take out insurance in respect of a member; to buy or sell and individual asset.

In all of these cases, there is a general duty or power vested in the trustee to do a certain thing. It is then up to the trustee to decide the detail as to how it is done. How many of these details are deemed incorporated into the governing rules of the fund? How is a trustee to decide what is an amendment and what is a simple resolution?

Retrospective, or at Least Retroactive

There is no question that the Government can restrict access to the defined benefit pension grandfathering provisions as much as they wish. They could have replaced the words "provide for" in Regulation 9.04F with the words "contain the terms and conditions of". To have done so would almost certainly have led to charges of retrospective, or at least retroactive, changes (on the basis that the law did not previously require the terms and conditions to be included in the deed, but suddenly granted special privileges to those with deeds drafted in this manner). Instead, the retroactivity of the new Regulation comes from a new, previously unknown and unforeseen interpretation of the existing definition of "governing rules".

If we believed that such an interpretation of the existing legislation was reasonably open, we would not be bothering the Committee with this submission. However, we believe that the present interpretation is arbitrary and fundamentally alters the way in which trustees of superannuation funds go about their business.

Trustee Meetings Become a Minefield – Large Funds Affected, as Well

Trustees will now need to decide, each time they sit down to meet, whether any given decision or document which is tabled will constitute an amendment to the rules governing the fund. They will also need to go back and review every decision they have made since the present definition of "governing rules" was inserted into the *SIS Act*, to determine which resolutions they have passed constitute an amendment to those rules and which do not. Where the rules require that certain other parties be involved in, or approve any amendments to the fund's governing rules, they will need to decide whether they can simply have the other parties affirm the amendments *ex post facto* (unlikely), or whether they have breached their duties under the deed and what the likely consequences of such a breach would be.

Such a situation is not limited to SMSF's, as the definition of "governing rules" in Section 10(1) applies to all regulated superannuation funds. As large superannuation funds hold many more meetings than small funds do, it would be interesting to know how they feel about this interpretation. It would also be interesting to know if the large fund regulator, APRA, shares this understanding.

Trustees of all superannuation funds now have no guidance determining how, when or why they may have amended their governing rules, as the Explanatory Statement and the draft determination effectively say nothing more than, "sometimes a resolution is an amendment to the rules, sometimes it is not – this time, it is."

The Stamp Duty Bogie

These are just some of the unintended consequences and mischief created by this interpretation, however there is one more, which is likely to please the various State revenue authorities, but cost superannuation funds throughout the country a large sum of money. In many States and Territories, when a superannuation fund amends its governing rules it must submit the amending document for stamping, to which a concessional rate of duty (usually between $10 and $20) is applied. [In Queensland and Western Australia no duty is payable, but the document must still be submitted and stamped.] The administrative costs associated with lodging these documents must also be considered, as it is almost always more expensive than the duty payable.

So, if the "terms and conditions" argument prevails, we would expect that every superannuation fund – large and small – throughout the country would need to review past trustee decisions and documents, divine which ones might constitute an amendment pursuant to the "terms and conditions" argument, then submit them to their State revenue authority for stamping.

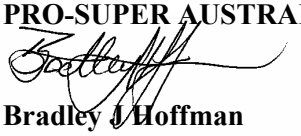
As noted above, although we would prefer that all SMSF's be able to continue to pay defined benefit pensions, it is the Government's prerogative to create two classes of SMSF – those which can and those which cannot pay defined benefit pensions. However, the correct way to achieve this goal is to make clear-cut regulations to effect this intention, rather than to adopt highly confusing and opaque interpretations of existing provisions.

Only Super Funds? Why Not Companies, or Parliaments?

The amendment of a fund's governing rules is a serious matter and one which has similarly serious consequences for a trustee. The rules which govern, empower and constrain any organisation must be readily ascertainable by marking a clear trail of those documents which evince an obvious intention to say, "our rules were previously thus, we are now altering those rules in this manner and we have adhered to the protocols we are required to follow for such alterations". This is the way in which companies amend their constitution and parliaments amend their laws. Until this new interpretation, it was also the way in which superannuation funds amended their governing rules.

Explanatory statements to new regulations are important documents, used by regulatory authorities and affected parties, alike, to help discern the Parliamentary intent. We would urge the Committee to review the parts of the Explanatory Statement to *Superannuation Industry (Supervision) Amendment Regulations 2004 (No.2)* which this submission addresses and offer their opinion on it.

Yours faithfully,
PRO-SUPER AUSTRALIA PTY LTD



Bradley J Hoffman
Managing Director

Our Company
Pro-Super provides technical superannuation advice to accountants and financial planners throughout Australia. We assist self-managed superannuation funds to establish and amend their trust deeds and provide technical advice to practitioners. In addition, we have assisted in the establishment of many pensions (allocated, lifetime and life expectancy) and administer SMSF funds on behalf of accountants and planners.

The managing director of Pro-Super Australia Pty Ltd, Brad Hoffman, holds Bachelors of Commerce and Laws and is a professional member of the National Institute of Accountants. He has been advising on superannuation technical issues for over 14 years.