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26 July 2002

Ms Sue Morton
Secretary
Select Committee
On Superannuation
Parliament House
CANBERRA ACT 2600

Dear Ms Morton

Transcript of evidence and supplementary materials of superannuation and standards of living in retirement Public Hearings in Sydney 9 July 2002

The Australian Institute of Company Directors (AICD) undertook to provide additional material in response to questions taken on notice at the Public Hearings in Sydney on 9 July 2002 of the Select Committee on superannuation and standards of living in retirement.

Please find attached:

1. Table of AICD proposed superannuation tax regime impact per submission of 9 July 2002 in response to question from Senator Allison on page 192 of the proof transcript of evidence.
2. Investment & Financial Services Association (IFSA) position paper "Complying Account Based Income Streams" in response to question from the Chairman Senator Watson on pages 187 and 188 of the proof transcript of evidence.

The AICD appreciates the opportunity to provide this additional information and to appear before the committee. Should the committee require any further information please do not hesitate to contact me on 02 8248 6630.

Yours faithfully

Rob Elliott
Policy Manager/Co Secretary/Legal Counsel

cc Simon Marks-Isaacs, Chairman AICD Taxation & Economics Committee
Stephen Hopley – AICD Taxation & Economics Committee member

Superannuation and standards of living in retirement

Question to Australian Institute of Company Directors taken on notice at the Public Hearing in Sydney 9 July 2002

Existing Superannuation Tax Regime – 2002/03

Taxable income	Tax rate on income (including medicare levy)	Contributions tax on superannuation	Surcharge on superannuation contributions *	Total tax on superannuation contributions (if govt proposals legislated)	Net incentive to invest in superannuation
6,000-20,000	17.0%	15.0%	Nil	15.0%	2.0%
20,001-50,000	31.5%	15.0%	Nil	15.0%	16.5%
50,001-60,000	43.5%	15.0%	Nil	15.0%	28.5%
60,001-90,526	48.5%	15.0%	Nil	15.0%	33.5%
90,527-109,924	48.5%	15.0%	1.35% – 13.5%	16.35% – 28.5%	32.15% - 20.0%
109,925 upwards	48.5%	15.0%	13.5%	28.5%	20.0%

AICD Proposed Superannuation Tax Regime – As Per Submission of 9 July 2002

Taxable income	Tax rate on income (including medicare levy)	Contributions tax on superannuation	Rebate on superannuation contributions	Total tax on superannuation contributions	Net incentive to invest in superannuation
6,000-20,000	17.0% but N/A	15.0%	30.0%	(15.0%)	15.0%
20,001-50,000	31.5% but N/A	15.0%	30.0%	(15.0%)	15.0%
50,001-60,000	43.5% but N/A	15.0%	30.0%	(15.0%)	15.0%
60,001-90,526	48.5% but N/A	15.0%	30.0%	(15.0%)	15.0%
90,527-109,924	48.5% but N/A	15.0%	30.0%	(15.0%)	15.0%
109,925 upwards	48.5% but N/A	15.0%	30.0%	(15.0%)	15.0%

IFSA POSITION PAPER
COMPLYING ACCOUNT BASED INCOME STREAMS

Background

In its 1997 Budget, the Federal Government announced that it proposed to introduce a new class 'complying' superannuation pensions and annuities, which would receive favourable social security and tax treatment.

The Investment and Financial Services Association (IFSA) has consistently supported the public policy objectives behind this proposal:

- increase competition in the provision of 'complying' income stream products;
- increase overall incomes of retirees through better internal yields from a wider range of 'complying' product and risk types;
- continue the objective that 'complying' products facilitate the orderly drawdown of capital over retirement;
- limit inappropriate opportunities for tax deferral and asset test avoidance (including e.g. use of 'complying' products to shield assets from taxation and asset testing while preserving assets into estates); and
- increase downward pressure on purchase costs through a wider choice of 'complying' income stream products.

Draft legislation to this effect was released in 1997 and after some industry consultation the *Social Security and Veterans' Affairs Legislation Amendment (Budget and Other Measures) Bill 1997* was enacted. Means test rules for a new class of 'life expectancy' products took effect from 20 September 1998.

At the time the exposure draft of the legislation was released, Treasury committed to release a discussion paper to address a range of issues, including the appropriateness of account-based (or allocated) products. This paper has not been issued to date.

Complying Income Stream Products

In this paper, 'complying' indicates that a product qualifies for the following regulatory treatment:

- assessed toward the pension (rather than lump sum) Reasonable Benefits Limit (RBL); and
- exempt from the social security assets test; and

Complying income streams also share treatment with other income streams:

- exempt from income tax on its earnings (prior to distribution), and
- assessed under the social security income test rules for income streams (as opposed to the rules for managed investments).

Shortcomings of the current income stream offerings

It is IFSA's view that the policy aims of the 1998 income stream rules are not being achieved in full. A transparent account-based income stream, invested in a balanced portfolio, would round out the options available to retirees.

The current social security and superannuation rules prevent the development of these products by requiring that annual payments in complying account-based income streams do not vary, except for indexation. Tested against the policy intentions outlined above, this particular rule appears to be a provision of technical regulation, rather than an expression of policy. Alternative rules could be developed to meet the same policy objectives without preventing the development of new products.

- While the rule does help to ensure the orderly drawdown of capital, IFSA proposes other measures in this paper, which would achieve the same effect.
- The rule also limits access to asset test exemptions to those income streams that exhaust capital during the retiree's life expectancy (or lifetime). IFSA proposes measures in its model, which would similarly – and more directly – guarantee that capital is used up within a retiree's life expectancy.

If the legislation is not amended to allow account style products backed by balanced portfolios, we consider that retirees affected by the assets test will continue to have strong incentives to take out either:

- complying income stream products backed by interest bearing securities, which produce historically inferior returns in comparison to balanced portfolios; or
- complying income streams, with complex benefit designs, effected through SMSFs. In these arrangements, estate planning is a key consideration: surplus assets remain in the reserves of the SMSF after the death of the pension recipient. This reserve is then paid to other members of the fund (who tend to be the family of the member) and the nil RCV rule is effectively circumvented.

The benefits of any improvement on the current law in this regard should be assessed against any cost to Government (either in terms of loss of revenue or increased social security expenditure). In a later section we provide comment on the means by which Government costs might be constrained.

The current rules produce distortion in resource allocation, and thus are economically inefficient. Since life expectancy and lifetime products are backed (in the main) by interest securities, the effective investment is in debt, rather than in

equity. Income streams backed by balanced portfolios would have an appropriate level of investment in equities, and hence would be more economically efficient. Experience with allocated products shows that, without the distorting effect of the 'no variation in payments' rule, retirees prefer to invest in a balanced and economically efficient portfolio.

The introduction of the current rules has not produced any real increase in the number of income stream providers. The market for complying income streams is still limited to a small number of providers, reflecting the capital requirements required to operate a guaranteed income streams.

The case for complying account based products

A complying account-based income stream is one where:

- retirees invest a lump sum in one or more of a range of investment portfolios (including balanced or growth asset portfolios), the value of which would be reflected in an account balance;
- the recipient is required to draw a specified proportion of the account balance as income in each year, so that the account is exhausted on the life expectancy of the recipient;
- the account cannot be closed ("commuted") except in limited circumstances, such as to purchase another complying income stream (as for current complying products).

While a complying account-based income stream would have much in common with the basic design of an allocated pension or annuity, IFSA believes it would meet the public policy objectives outlined earlier in this paper. That is, it would have significantly tighter constraints on income than ordinary allocated income streams, and importantly would not allow access to capital (except in limited circumstances, as described).

Account-based or allocated products have strong attractions for retirees over guaranteed (term certain) or lifetime products. They are simple, transparent (especially for fees) and give a sense of investment ownership and control. Most importantly, they provide a means for ordinary retirees to use a balance of growth and defensive assets to generate income while facilitating the orderly drawdown of capital across retirement. Retirees who purchase account–based products overwhelming select balanced portfolios.

As a result, allocated products have been able to attract retirees away from lump sums where term (including life expectancy) and lifetime products have not. Regulatory recognition of allocated products has been critical to this success.

> *Regulatory recognition of account-based products as complying income streams (appropriately constrained) is likely to be acknowledged as another milestone in the development of policy to encourage retirees to choose long term income streams.*

An account–based product has other advantages over an interest-bearing product:

- Historically, balanced portfolios produce significantly better returns than interest bearing ones over investment periods of 15 years or so.
- These superior returns would generate a greater level of self-sufficiency for retirees.

- In practice, competition between providers of complying interest-bearing products is somewhat limited. Availability of complying account–based products would open the market up dramatically to a broad range of balanced portfolio managers.
- In IFSA's view, complying account based income streams sit well with the Government's proposals for freedom of choice of fund and of portability of benefits. Regulatory recognition of these products would broaden an individual's choice of providers and choice of investment options in the benefits phase of superannuation. Whether or not superannuation fund choice is able to be implemented, it would be disappointing if whatever choice exists for pre-retirement superannuation fund members is limited at retirement by restrictions which impel retiring superannuants to skew the allocation of their superannuation savings towards interest-bearing securities to an undesirable degree.

A complying account-based income stream would have the following advantages over a SMSF complying pension:

- transparent allocation of income and capital, since the complex administration necessary to produce the desired estate planning result would be unnecessary;
- full application of the account balance towards provision of income during the life of the income stream recipient;
- no difficulties in the tax treatment of reserves (which have arisen in relation to defined income streams);
- no income deferral, since the special pension valuation factors for account-based products (see below) ensure income is drawn down over life expectancy; and
- availability to retirees who do not have their savings in the superannuation system (if non-superannuation annuities were to be allowed).

IFSA's Specific Solution

IFSA proposes that the rules for complying products be broadened to include a new complying product category. Products recognised would have the following features:

- **non-commutable** except in defined circumstances (as with current complying products);
- **no residual capital value** upon expiry of term of the product
- **term** to be life expectancy at the investor's age either upon purchase of the product or at some earlier age, such as life expectancy at age less eight years, (basis used by the Australian Government Actuary for asset test value of an income stream, that is, for a 65 year old, use the life expectancy of a 57 year old); and
- **income** payable each year determined by reference to a pension valuation factor as set out below (i.e. no drawdown between maximum and minimum values). That is, the total amount of the payment to be made is determined in accordance with the following formula:

$$\frac{AB}{PVF}$$

where: **AB** = the amount of the annuity or pension account balance
PVF = the maximum pension valuation factor determined by the following formula:

Payment valuation factor = $\frac{1-v^n}{i}$ (limited to a minimum of 1)

where **n** = the client's life expectation factor less the number of years elapsed
v = $\frac{1}{1+i}$
i = a factor to be set by the Commissioner. (A factor of 0.06 is recommended)

Example using current life expectancy as basis for term

Mr Jones is 65 and invests $100,000 into an account-based complying pension on 1 May 2001. His life expectation factor is 16.21 (round up to 17).

His payment for 2000-01 is calculated as:

$n = 17-0 = 17$
$i = 0.06$
$v = \frac{1}{1.06}$

PVF = $\frac{1-(1/1.06)^{17}}{0.06}$ = 10.5 (rounded to 1 decimal place).

Payment = $\frac{100{,}000}{10.5} \times \frac{61}{365}$ = $1,590 (rounded to nearest $10).

On 1 July 2001, the PVF would be recalculated, but as Mr Jones has only been in the pension for 2 months, his time elapsed is still 0 years (to the nearest year), so **n** = 17 – 0 = 17. The PVF will not change from 10.5.

In 1 July 2002, he has been in the product 1 year and **n** = 17 - 1 = 16. The PVF will be:

$$\textbf{PVF} = \frac{1-(1/1.06)^{16}}{0.06} = 10.1 \text{ (rounded to 1 decimal place).}$$

Example using life expectancy at current age less eight years

Usage of life expectancy at current age less eight years (rather than life expectancy at current age) has the advantage of allaying concerns retirees may have about income running out too early.

Mr Jones is 65 and invests $100,000 into an account-based complying pension on 1 May 2001. The life expectation factor at age 57 is 22.52 (round up to 23).

His payment for 2000-01 is calculated as:

$$\mathbf{n} = 23-0 = 23$$
$$\mathbf{i} = 0.06$$
$$\mathbf{v} = \frac{1}{1.06}$$

$$\textbf{PVF} = \frac{1-(1/1.06)^{23}}{0.06} = 12.3 \text{ (rounded to 1 decimal place).}$$

$$\text{Payment} = \frac{100{,}000}{12.3} \times \frac{61}{365} = \$1{,}360 \text{ (rounded to nearest \$10).}$$

On 1 July 2001 the PVF would be recalculated, but as Mr Jones has only been in the pension for 2 months, his time elapsed is still 0 years (to the nearest year), so **n** = 23 – 0 = 23. The PVF will not change from 12.3

In 1 July 2002, he has been in the product 1 year and **n** = 23 - 1 = 22. The PVF will be:

$$\textbf{PVF} = \frac{1-(1/1.06)^{22}}{0.06} = 12.0 \text{ (rounded to 1 decimal place).}$$

Alternative approaches to variations in annual payments

Current social security assessment rules require that payments do not vary from year to year (except for indexation). FaCS has expressed a concern that annual payments from account-based products could vary – and in particular that payments could decrease in the year following poor investment returns.

The first and most important point is that overall returns from income streams invested in balanced or growth portfolios generally exceed returns from interest-bearing securities. This is true to a very high degree of probability in the long run

and, depending on the portfolio selected, it can hold in short-run scenarios as well. This means that both retirees and pension outlays will benefit in the long run. Pensioners will have higher overall income and income assessed under both social security and income tax rules will be higher than for interest-bearing securities.

In terms of individual impact, retirees would be able to select products or portfolios which best suit their needs. Market volatility does not appear to be an issue for individuals purchasing allocated products, and should not be any more troublesome for complying account-based income streams.

Government risk from volatility in complying account-based income streams should be more than outweighed by benefits. The fixed formula for income drawdown (as opposed to current allocated products) means that higher returns will be directly translated into higher assessable income for both tax and social security. The social security income test deduction rules also set a floor below which low returns cease to have an effect on outlays. Government has a fairly simple long-run trade-off between return and volatility – with the benefit of a cap on down-side risk (through the income test rules).

There are a range of options to limit the effect of volatility on revenue and outlays. IFSA suggests that volatility is not a major issue, on the basis that:

- retirees can select a portfolio based on their income needs and risk tolerance; and
- government would benefit by accepting small volatility for revenue and outlays benefits, as well as to retain simplicity and transparency in assessment rules.

However, IFSA accepts this is a question for Government to resolve and would be happy to explore any options with Government.

Stochastic modeling indicates that, even in the short-term, there is a strong likelihood that the income level from a complying account-based product will exceed income from an indexed conventional complying life expectancy product.

GOVERNMENT COSTING CONSIDERATIONS

IFSA understands Government is concerned that this proposal may have fiscal costs. This could occur in two ways.

- **Assets test**: age pension outlays would rise if asset tested retirees, *who would not otherwise take up asset test exempt income streams*, are attracted into complying account-based income streams. This potentially includes:
  - retirees who would not receive any age pension under the assets test, but who would be bought under the assets test cut-out point on purchase of a complying account-based income stream; and
  - retirees who receive age pensions under the current means tests, but who would received an increased rate of pension on purchase of a complying account-based income steam.

- **Income test**: age pension outlays would rise if income tested retirees, *who would not otherwise take up income streams which qualify for deductions based on full purchase price*, are attracted into complying account-based income streams. (As we point out below, this would occur extremely rarely – if at all)

This concern appears to be based on a perception that account based products are likely to be significantly more popular than the current range of complying income streams. Complying account-based income streams may be more attractive than life expectancy or lifetime products (with their attendant investment asset allocation limitations), or SMSFs (which face significant administrative complexity to produce similar outcomes). However, this attraction does not necessarily lead to higher pension outlays.

This fiscal concern is likely to be misplaced in at least 3 significant respects.

- IFSA anticipates there will be substantial substitution from current assets test exempt incomes streams.

- Complying account-based products are highly likely to increase the amount of income assessed under the income test, actually reducing outlays. This would occur when retirees choose complying account-based products over other asset test exempt income streams. Higher income flow from these products will reduce pension payments under the income test - and retirees will have higher overall incomes.

- Recent growth in SMSFs as a means to provide complying pensions, backed by balanced or growth asset portfolios, has already extended the reach of complying income streams under the existing law. This trend looks set to increase. As this occurs, the substitution effect from complying account-based pensions becomes larger because more purchasers of complying account-based products would receive the same means test treatment anyway. (*See **Policy and Fiscal risk from SMSFs** – below*)

IFSA welcomes the opportunity to explore the size of the substitution effect, and to test the outcomes of the two countervailing fiscal influences (increased take-up of asset test exempt products against increased income assessed from complying account-based income streams). IFSA understands that Treasury and FaCS have made some estimates of future income stream demand, based on income data.

In addition to testing the likely substitution effect, IFSA believes it is possible for the Commonwealth to develop rules, in partnership with industry, which encompass complying account-based products at an acceptable level of fiscal risk. A range of constraints could be imposed to limit potential fiscal exposure – without risking potential fiscal gain.

Substitution from current assets test exempt income streams

The size of the substitution effect between asset test exempt product categories is a critical question - the higher the substitution effect, the lower the Commonwealth fiscal risk from complying account-based products. Based on trends discussed earlier, IFSA believes the substitution effect among potential purchasers of complying account-based income streams will be close to complete.

Interest-based income streams (life expectancy and lifetime) could be expected to have a significant substitution effect, due to higher income and greater transparency of account-based income streams. IFSA believes that a very high proportion of life expectancy products are purchased primarily for their assets test exemption, not because of their intrinsic attraction to retirees. The proportion of lifetime products purchased for assets test reasons might be somewhat lower (due to the effect of adverse selection on longevity risk), however these products are purchased by a very small proportion of retirees.

Substitution is also likely to occur from SMSF asset test exempt income streams. IFSA members report that retirees generally find the administrative burden of SMSFs to be higher than they would wish in retirement. However, in the absence of alternative products invested in balanced portfolios, retirees appear ready to trade off administrative complexity for higher return. The capacity to avoid the "no residual capital value" rule for asset test exemption presents an additional incentive (*See **Policy and Fiscal risk from SMSFs** – below*).

Support for a high to complete substitution effect from current complying income streams flows from the increase in education and marketing effort for these products. Extensive marketing and education programs, combined with widely available software tools to demonstrate complying income streams, suggests that most retirees who could use current complying products to reduce their assets test exposure would already be doing so. There is a similar story for SMSF complying income streams. Since these retirees form the target group for complying account-based income streams, higher levels of take up of current complying products leads directly to a higher substitution effect.

'New' take-up of complying account-based income streams

The obverse of substitution between current assets test exempt income streams is to examine what 'new' take up of assets test exempt income streams might occur if complying account-based income streams are introduced. As set out above, 'new' take-up occurs if retirees who *would not otherwise* purchase a complying income stream, purchase a complying account-based product.

IFSA believes new take up will be miniscule compared to substitution from current complying income streams. Complying account-based income streams would represent a definite improvement over life expectancy products for almost all

retirees, and over lifetime products for many retirees (depending on anticipated longevity). However, it is highly likely that most, if not all, retirees would select a complying product in any case. Reasons for selecting complying lifetime or life expectancy products, even on a 'second best' basis, are outlined above. Motivations for choosing (lifetime) pension deliver through SMSFs are discussed below.

IFSA does not believe there will be significant substitution between allocated products and complying account-based income streams. Retirees who hold allocated products yet still wish to reduce their assessable assets would already be doing so by means of lifetime or life expectancy income streams. This means substitution would be occurring between currently asset test exempt income streams and complying account-based income streams. Where the assets test is not an issue, the greater flexibility of allocated products – with the same degree of investment transparency and control – would them stronger attraction for retirees.

Potential 'new' purchasers of complying account-based income streams, after these two groups are excluded, are:

- retirees who would have purchased a complying product (life expectancy, lifetime or SMSF), but for barriers in either of
    - low yields and/or lack of transparency (life expectancy and lifetime products), or
    - administrative complexity (SMSFs); and
- retirees who would not have purchased a complying product, but would consider a complying account-based income stream.

Possible cost constraints

IFSA does not believe, given the considerations discussed above and based on stochastic modeling, that there would be additional costs arising from recognition of complying account-based income streams. However, IFSA does understand that Government is concerned at the possibility of increases to age pension outlays. IFSA is happy to explore possible fiscal constraints within the broad public policy objectives set out at the beginning of this paper.

Since complying income streams would be exempt from the assets test, government may wish to explore the reach of these exemptions. IFSA's proposed model would not provide access to capital, except in the same limited circumstances as current asset test exempt products. This meets the policy test for exemption from asset testing. However, if government wishes to explore them, IFSA would be prepared to discuss options such as:

- an assets test exemption of less than 100%; or
- a ceiling on the total assets test exemption for individuals.

Cost constraints inherent in this proposal

There are some cost constraints inherent in IFSA's proposal for complying account-based income streams. These are discussed in more details earlier in this paper.

- The long–run level of income modeled for by these products is higher than that generated by current fixed income complying products.

- The long –run level of income generated by these products is likely to be considerably higher than the income generated by a typical self managed superannuation fund version (which involves reserving of assets).
- The fixed income drawing limits deferral of income derived by the underlying fund, in contrast to both allocated products and to SMSFs. Indefinite income deferral (available through SMSFs) is avoided altogether.

Policy and fiscal risk from SMSFs

At various points in this paper we have pointed out that there is considerable potential to use income streams delivered through SMSFs to avoid the income and assets tests. We have drawn attention to this potential because we believe that a significant number of retirees who may be attracted to SMSF income streams would actually prefer a complying account-based income stream. IFSA is also concerned that the possibility of widespread avoidance may threaten the integrity of retirement incomes regulation and public income support.

We have outlined above the means by which SMSFs can avoid the requirement of no residual capital value for assets test exemption. This is achieved by selecting an income rate that does not exhaust the capital contributed. The capital remaining on the death of the pensioner is distributed to family members via the reserves of the SMSF. (If the deprivation rules are applied to an excess asset value at the commencement of the pension, they will only apply for [5] years, after which time the whole value of the assets contributed will be effectively exempt for the assets test.)

A similar outcome can arise if the assets backing a SMSF complying income stream outperform projections. A reserve then builds up in the SMSF, which can be passed on to other fund members, while the level of income assessed for social security remains low (or even zero).

The policy risk arising from these strategies is that the public policy objectives of the assets test exemption can be circumvented. Only limited draw down of capital occurs over the life of the retiree, and public income support has been provided at a level higher than to other retirees with similar resources. The fiscal risk is that pension outlays will be higher where the application of the assets test is limited or avoided, and tax revenues will be lower where the reasonable benefits limits are avoided or the value excessive benefits is limited.

This strategy can also be used to limit assessable income. Where a low level of income is selected, little or no income may be counted towards the income test, increasing outlays. Assessable income for tax may also be limited, reducing revenue.

Evidence of use of these strategies, and of increases in use of SMSFs for complying pensions, is largely anecdotal at this stage. IFSA is aware that FaCS has access to age pensioner data that would show any increase in SMSF complying pensions, and data that would show the amount of assets backing those pensions. Analysis of this data should give an indication of the degree of exposure to SMSFs as avoidance vehicles.

IFSA also notes that these strategies are the subject of open discussion in the financial advice community.

Further costing and consultation

IFSA would like to continue discussion with FaCS and Treasury to agree costing assumptions and examine the fiscal impact of complying account-based income streams. In this paper, we have explored a range of factors related to the fiscal cost or savings arising from complying account-based income streams. IFSA has data and modeling for some of these considerations, while some data is held by Government.

We have also raises a number of options to limit fiscal risk to the Commonwealth, which IFSA would like to explore further with FaCS and Treasury.

February 2001