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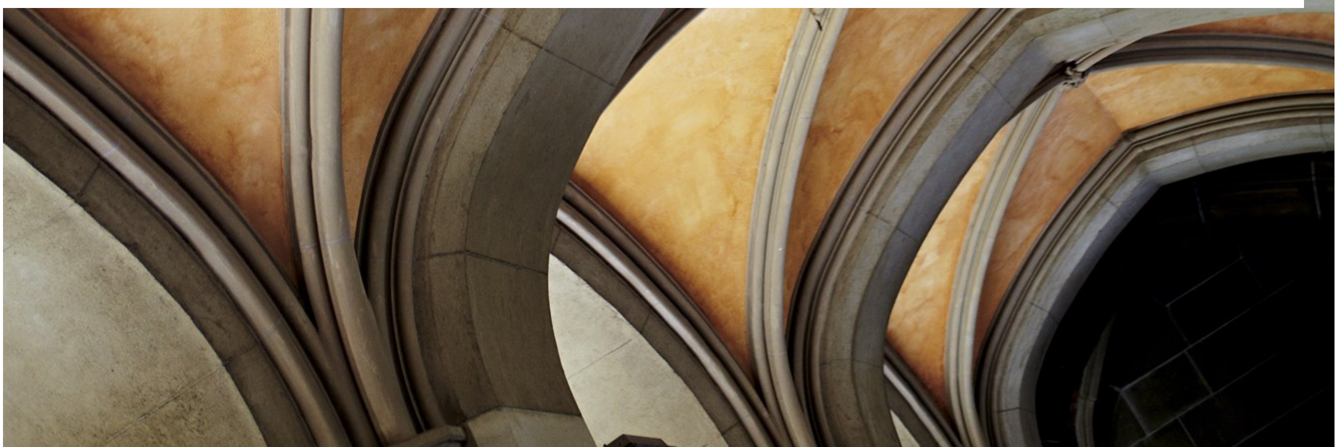

Superannuation reform package

Submission by UniSuper

21 October 2016

About UniSuper

UniSuper[1] is the superannuation fund dedicated to people working in Australia's higher education and research sector. With approximately 400,000 members and around $57 billion in net assets under management, UniSuper is one of Australia's largest superannuation funds and has one of the very few open defined benefit schemes.

We are pleased to comment on the exposure draft legislation to give effect to the superannuation measures announced in the 2016-17 Budget. We note that the Government is still considering the appropriate treatment of excess non-concessional contributions that result from *compulsory* non-concessional contributions made to defined benefit interests. As a result, we find it difficult to comment fully on the exposure draft because we believe that additional consideration needs to be given more broadly to defined benefit issues, including the proper treatment of *all* non-concessional contributions to defined benefit schemes as well as the valuation rules for defined benefit interests.

UniSuper Management Pty Ltd would welcome the opportunity to discuss the submission further and to provide additional information in respect of the comments made in this submission. Should you have further queries, please contact Benedict Davies on (03) 8831 6670 or benedict.davies@unisuper.com.au

Comments on tranche three: defined benefit issues

Valuing defined benefit interests for the "total superannuation balance" threshold

In the exposure draft, it is proposed that eligibility to make non-concessional contributions would be determined by reference to a member's "total superannuation balance". This threshold would be pegged to the transfer balance cap of (currently proposed) $1,600,000. The rules for valuing a defined benefit interest (i.e. age-based factors from Schedule 1B of ITAR 97) are different to those proposed for the transfer balance cap (i.e. an across-the-board valuation factor of 16).

We are concerned that using different factors to value the same interest is likely to result in confusing outcomes for members.

By way of example, the table below shows a 55 year-old member with entitlement to a defined benefit pension on retirement with a current annual benefit of $89,250. Each year the defined benefit pension entitlement increases in line with AWOTE – assumed to be 4% – until the member retires on his preferred retirement date of his 65th birthday. Each year leading up to his retirement, he closely monitors his eligibility to make non-concessional contributions and plans to transfer the full value of his defined benefit entitlement to the pension phase without paying additional taxes.

[1] This submission has been prepared by UniSuper Management Pty Ltd (ABN 91 006 961 799), which acts as the administrator of the Trustee, UniSuper Limited (ABN 54 006 027 121).

Financial year	$1.6m uprated by CPI	Age	Accruing DB pension entitlement	Non-Concessional Contributions test valuation	Transfer Balance Cap valuation
2017/18	1,600,000	55	89,250	1,599,985	1,428,000
2018/19	1,600,000	56	92,820	1,639,108	1,485,120
2019/20	1,600,000	57	96,533	1,613,490	1,544,525
2021/22	1,700,000	58	100,394	1,587,222	1,606,306
2022/23	1,800,000	59	104,410	1,560,304	1,670,558
2023/24	1,800,000	60	108,586	1,532,737	1,737,380
2024/25	1,900,000	61	112,930	1,504,519	1,806,876
2025/26	1,900,000	62	117,447	1,475,003	1,879,151
2026/27	2,000,000	63	122,145	1,444,094	1,954,317
2027/28	2,000,000	64	127,031	1,412,071	2,032,489
2028/29	2,100,000	65	132,112	1,379,398	2,113,789

Assumptions: For the NCC test, the defined benefit pension entitlement is valued using the factors for indexed lifetime pensions from Schedule 1B of the Income Tax Assessment Regulations 1997. For the TBC test, a multiple of 16 has been used each year based on an accruing pension entitlement.

The $1.6m threshold / cap has been uprated by CPI of 3% and rounded. We note that the NCC threshold will in fact be indexed to AWOTE rather than CPI which is the proposed index for the TBC.

Over time, these two caps could fall out of alignment.

Age	ITAR factor for NCC test above	TBC factor for test above
55	17.927	16
56	17.659	16
57	17.383	16
58	17.100	16
59	16.810	16
60	16.513	16
61	16.209	16
62	15.891	16
63	15.558	16
64	15.213	16
65	14.861	16

The above table shows that, for the first three years, the member would exceed the non-concessional contributions (NCC) threshold but manages to remain under the transfer balance cap (TBC). Over time, however, the situation reverses and as he gets closer to retirement the value of his defined benefit pension rights approaches and then exceeds the transfer balance cap. At the same time, his pension rights (which haven't changed) have been valued below the NCC threshold for the preceding eight years.

It would be an odd outcome if a member received notice from the ATO that he was below the NCC threshold of $1.6m one day, and the next day, on retirement, told that he failed a different test that valued his pension interest to be greater than $1.6m. This would be an odd and confusing outcome.

We strongly encourage aligning the two tests to prevent confusion. Our preferred approach, as per our earlier submission on tranche two, would be to use actuarially-based commutation factors that more adequately value a defined benefit interest than either of the above methods. (A uniform approach to the threshold / cap would also help address the potential adverse consequences of these amounts being indexed at different rates viz. CPI and AWOTE, which could mean that in some years the caps would be out of alignment.)

We believe that commutation factors are also a fairer method for valuing defined benefit pension rights because they better represent the real – or in some cases hypothetical – alternative use of those funds (i.e. at retirement a pensioner may choose to commute some or all of his or her defined benefit pension and use that pot of money to commence an account-based pension or purchase an annuity). If the defined benefit pension were to be overvalued vis-à-vis its alternative, we are concerned that this would create an incentive to take a mix of lump-sums and income streams that could be sub-optimal.[2]

Consequence of exceeding the NCC cap with defined benefit contributions

The exposure draft also includes a policy that would allow for ongoing eligibility to make contributions to a defined benefit scheme. This policy is to be welcome and it recognises that many members will wish to continue funding a defined benefit entitlement and are prepared to reduce their overall superannuation balances accordingly.

While we support this approach, we are concerned that if a member reaches the proposed total superannuation balance and wishes to continue making on-going contributions to his or her defined benefit, the full force of the excess non-concessional contributions regime would apply. The member would need to release an amount equal to the excess non-concessional contributions *plus* an associated earnings amount which will be included in a member's assessable income.

The associated earnings rules were introduced in 2014, and assume that any excess contributions earn an amount equivalent to the General Interest Charge (GIC), currently 9.2% per annum. The rules also calculate the earnings from the 1st of July in the year in which the excess contribution is made until the liability has been discharged. In many instances, this would overstate the true earnings on the excess and acts as a penalty regime to discourage deliberate abuses of the NCC cap.

In the case of a person choosing to fund a defined benefit entitlement – particularly for one who is prepared for the *quid pro quo* of reducing their overall superannuation balance – a penalty regime is neither necessary nor fair.

We submit that consideration should be given to an alternative assumed earnings rate. Options include the 10-year Treasury bond rate (which is currently used in the case of Division 293 deferred debts) or a new measure more in line with wages growth, such as AWOTE (which is commonly used to index many defined benefit entitlements prior to their payment). Both of these methods are expected to be better aligned to the actual earnings on the contributions made to fund defined benefit entitlements. Adoption of either method would recognise that additional contributions to defined benefit schemes are not done to contravene the caps.

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[2] This could also influence a person's decision about when to retire