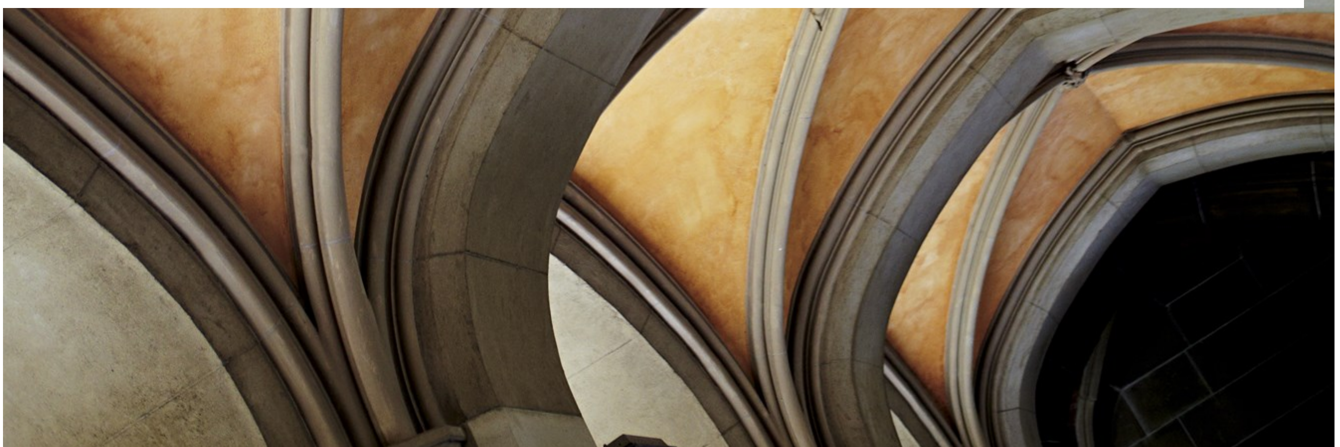
UniSuper

Superannuation reform package

Submission by UniSuper

10 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.

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

[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).

UniSuper

Executive Summary

- While we make no comment on the size of the Transfer Balance Cap (TBC), we do, however, have a number of concerns about its application to defined benefit income streams.
- The Transfer Balance Cap (TBC) includes special valuation rules that over value many defined benefit pensions. This raises a number of equity issues, particularly horizontal equity.
- We suggest an alternative valuation rule using scheme-based commutation factors to better address the horizontal equity and possible behavioural responses.
- Our alternative method would also help address some of the potential inequities in the proposed treatment of reversionary pensions.
- The new category of assessable income known as *defined benefit income* would include for the first time – from what we can establish – some amount of after-tax monies in assessable income.
- We submit that an exemption of the tax-free component calculated under the rules in section 307-125 should continue and consideration should be given to grandfathering holders of the Commonwealth Seniors Health Card on 3 May 2016.
- While we understand that the amount of concessionally-taxed superannuation cannot be unlimited, we would be concerned if policies that cap pension balances were introduced without prior rigorous modelling of the policies' impact on retirement adequacy and replacement rates. Detailed analysis should be prepared by an expert modelling unit, such as Treasury's Retirement Income Modelling Unit, to help inform the debate.
- On two previous occasions when the concessional caps were changed, special grandfathering rules were introduced.

  The policy basis for grandfathering (i.e. difficulty for members to reduce their contributions) has not changed. We strongly encourage further consideration to extending special grandfathering rules to newer defined benefit members, albeit at the cap that they were subject to at the time of the announcement.
- Proposed section 307-205 is confusing and potentially requires defined benefit interests to be valued annually based on the valuation factors in Schedule 1B of the Income Tax Assessment Regulations 1997. Currently, this calculation is done only once under the "proportioning rule" when a defined benefit pension becomes payable.
- There is a simpler alternative approach using the existing Member Contribution Statement process. Question 58 requires funds to report an account balance to the ATO based on a member's withdrawal benefit as at the last reporting date.

Comments on the transfer balance cap

While we make no comment on the size of the Transfer Balance Cap (TBC), we do, however, have a number of concerns about its application to defined benefit income streams. Our comments are about the proposed special method and would apply equally if the TBC were double (or half) the proposed limit of $1.6 million.

The proposed rules to calculate a special value for lifetime products are simple but, arguably, unfair. Applying the same valuation multiple to all lifetime income pensions would be fair only if all lifetime pensions had the same features and their recipients were all the same age. But that is not the case. The special valuation rules, therefore, raise a number of equity issues, particularly horizontal equity, which we outline below.

1. Equity issues based on age

An across-the-board valuation factor of 16 does not take into account the fact that the value of a lifetime pension varies with the pensioner's age.

For example, a $100,000 lifetime pension paid to a 75 year old is less valuable than a $100,000 lifetime pension paid to a 60 year old. Annuity prices clearly reflect this fact and most, if not all, DB schemes that pay pensions recognise this in their benefit design.

In the case of UniSuper, our benefit design expressly recognises this. By way of example, one class of our defined benefit pensions "Division A" can be commuted at age 60 for a multiple of ten times pension, but at age 70, the commutation value is reduced to seven times.

The proposed valuation factor of 16 would mean that a Division A pension paid to a 70-year old would have a legislated special value *more than double* its commutation value.

2. Equity issues based on scheme design

An across-the-board valuation factor also does not take into account other valuation issues that arise within schemes and across schemes. Very few defined benefit pensions have exactly the same benefit design, and variations include:

- Indexation: e.g. CPI or AWOTE
- Reversion: e.g. no reversion or 75% reversion or 62.5% reversion (see below for additional comments on reversionary pensions)
- Guaranteed period: e.g. no guaranteed period or 10-years

Each of the above factors is taken into account when valuing pensions, and any proposed special value rules should reflect this.

We believe a fair alternative to a single pension factor of 16 is to use the commutation factors of defined benefit schemes. This will result in a fairer outcome because it will take into account age-valuation effects (above) and benefit design rules.

Using commutation factors will also better address possible behavioural responses to the proposed special value rules which over-value certain lifetime income streams.

UniSuper

3. Possible behavioural responses

There are likely to be behavioural responses to consider if valuation rules are applied independently of a member's age and pension features.

Many defined benefit pensions have most – if not all – of the features of a Comprehensive Income Product for Retirement (CIPR). And most defined benefit members with pension rights, make plans to "blend" their DB pension with another account-based pension. While the percentage mix varies based on their degree of risk aversion and amount of non-superannuation wealth, the optimal mix should not be influenced by changing tax and social security rules.

The FSI recognised this fact when it recommended that the means test (a similar special valuation approach) should "not discourage products that manage longevity risk [and] should aim to provide neutral treatment of products with longevity risk protection".[1]

These comments apply equally well in a tax setting and our analysis (below) suggests that if legislated multiples (such as the valuation factor of 16 included in proposed section 294-120) are greater than the fund's terms of conversion (typically, a pension valuation factor or commutation factor) many defined benefit pensions will be overvalued for tax purposes.

If that is the case, or even if it is perceived to be the case, there is a real risk that those with defined benefit pension rights will not choose the optimal defined benefit pension base. The optimal mix should be based on the features of each income stream e.g. based on a need for income in retirement, preference for stable, indexed income, longevity insurance, etc. rather than based on tax and social security consequences.

If the transfer balance cap is seen to be a cap that retirees choose to "maximise", it is likely that account-based (and similar) pensions could be perceived to be more generously treated.

Example – base case

Member, 65, has a defined benefit interest, that would pay an indexed pension of approximately $83,1000 (valued by the fund at $1,000,000) and an accumulation balance of $430,000 with which he intends to purchase an account-based pension.

The combined superannuation interests (above) could be thought of as a 70:30 CIPR, which could be the optimal mix for that member, depending on his or her circumstances. However, after the TBC is applied (see over page), the combined amounts would now be in excess of the $1.6 million cap by virtue of the high conversion factor of 16. This would give rise to an excess amount of approximately $162,000.

[1] Financial System Inquiry (FSI), Chapter 2:Superannaution and retirement incomes (2014)

	Base case 100% DB pension – $83,333
Defined benefit pension valued at a PVF of 12*	1,000,000
Defined benefit pension with a special value of 16 times	1,333,333
Account-based pension	**428,571**
Amounts transferred to pension phase	1,761,904
Transfer balance cap	1,600,000.00
Amount over cap	**161,904**

* A PVF of 12 is taken an approximation for valuing a 65 year old's pension rights but the figure will vary with age and scheme design.

While the behavioural response is hard to predict, we posit that many affected members will focus on the quantum of the cap and view one of the retirement planning objectives to take maximum advantage of this cap. In other words, we believe some members will be influenced by the proposed special value rules to reduce the amount they allocate to their defined benefit pension so as to get "more" money into the pension phase.

This can be seen (below), where the member now considers alternatives of taking 90% of his defined benefit pension or 80% or 70%, each time taking a smaller defined benefit pension. Each time the defined benefit pension is reduced, the excess reduces. Eventually a point is reached a second account-based pension (in addition to the existing $429,000) can be commenced as the unused transfer balance cap increases.

	100% DB pension entitlement - $83,333	90% DB pension entitlement - $75,000	80% DB pension entitlement - $66,667	70% DB pension entitlement - $58,333
Defined benefit pension valued at a PVF of 12*	1,000,000	900,000	800,000	600,000
Defined benefit pension with a special value of 16 times	1,333,333	1,200,000	1,066,666	933,333
Account-based pension	**428,571**	**428,571**	**428,571**	**428,571**
Amount transferred to pension phase	1,761,904	1,628,571	1,495,237	1,361,904
Transfer balance cap	1,600,000	1,600,000	1,600,000	1,600,000
Amount over cap	**161,904**	**28,571**	104,762	238,095
Additional ABP	nil	nil	**104,762**	**238,095**

It could be argued that this behaviour is myopic and that members in these circumstances, by failing to adequately evaluate the benefit of receiving a lifetime pension, are making a poor choice. However, the framing of this cap, we believe, will exacerbate this myopia rather than reduce it.

It is for the above reasons that we favour the use of actuarially-based commutation that offer a neutral treatment of defined benefit pensions vis-à-vis account-based pensions.

Reversionary & couple-based pension issues

We note that the value of reversionary superannuation income streams will count towards the recipient's transfer balance cap. These rules further highlight the above concerns with the treatment of defined benefit pensions.

Our defined benefit pensions include an in-built reversion (62.5%) to a pensioner's surviving spouse. On reversion, we also offer the option to commute all or part of the pension and receive a death benefit lump-sum in its place.

The new law will introduce an additional consideration for recipients of reversionary pensions i.e. will this reversionary pension affect other existing pensions and, if so, what to do about it? It is in these circumstances that the proposed special value rules are likely to over-value defined benefit pensions. If a pension were to revert to, say, a 90-year old on death of the primary pensioner, based on factors in our trust deed, we would offer a death benefit lump-sum of three times the pension, whereas the proposed special value rules would apply a factor of 16. That is more than five times greater, and is likely to influence the decision to commute the pension.

We believe that this further highlights the benefits of using scheme-based terms of conversion as opposed to the proposed special value factor of 16.

Defined benefit income

Division 302A of the Exposure Draft introduces a new category of assessable income described as defined benefit income. In the section above, our comments are independent of the size of the TBC and focus on horizontal equity issues arising from treating all DB schemes and scheme members alike. In this section, we raise a key principle of tax design that we believe is being compromised. Our comments would apply if the income threshold were $50,000 or $200,000 because the principle is an important one.

The defined benefit income rules would include for the first time – from what we can establish – some amount of after-tax monies in assessable income; that is to say, capital contributions (historically called undeducted contributions or, more recently, non-concessional contributions) will be included in assessable income and subject to additional tax.

This seems to breach a fundamentally important principle of good tax design and we submit that, on principle, the exemption of the tax-free component calculated under the proportioning rules in section 307-125 should continue.

Defined benefit pensions are typically funded by a combination of employer contributions, fund earnings and, for many funds, after-tax member contributions. In the case of UniSuper members, the defined benefit is funded by a 14% employer contribution (which ultimately adds to a defined benefit pension's taxable component) and a 7% standard member contribution (which ultimately adds to a pension's tax-free component).

Our records indicate that roughly 64% of our 7,000 current defined benefit pensioners have tax-free amounts greater than 10%. Further, 40% have tax-free amounts greater than 20% and 28% have tax-free amounts exceeding 30%.[2]

Arguably, the defined benefit income cap is set at a level which gives most taxpayers an effective deduction of their non-concessional contributions. The 50% exemption under proposed section 302A-5 also reduces the number of affected taxpayers. However, as a point of principle, it has long been the case that capital contributions are not subject to additional taxes. There is a risk that the long-established "tax compact" will be broken if this were to change and, particularly, if this measure were applied more broadly.

We should also like to highlight an important difference between the proposed excess transfer balance tax (applying, typically, to account-based pensions in excess of the TBC) and the proposed rules for defined benefit income: an excess transfer balance is not included in assessable income while "excess" defined benefit income is. As a result, affected defined benefit pensioners will have "excess pension amounts" included in the test for the Commonwealth Seniors Health Care Card while this would not be the case if they held an account-based pension. This, again, is likely to have behavioural responses with retirees choosing a mix of income stream to respond to the incentive (or disincentive) structure put in place by these tax rules. Consideration should be given to exempting defined benefit pension income from the Commonwealth Seniors Health Card, at least for pensions commenced prior to the announcement because, typically, they are not commutable.

Adequacy consequences should be clearly outlined

While we understand that the amount of concessionally-taxed superannuation cannot be unlimited, we would be concerned if policies that cap pension balances were introduced without prior rigorous modelling of the policies' impact on retirement adequacy and replacement rates. While the superannuation industry itself has undertaken similar exercises, we submit that policies like this should include detailed analysis prepared by an expert modelling unit, such as Treasury's Retirement Income Modelling Unit, to help inform the debate.

---

[2] For additional background information, please see our submission to the Senate Standing Committee for Community Affairs http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Community_Affairs/Fair_Sustainable_Pensions/Submissions

Comments on concessional superannuation contributions

We have long advocated for a more generous concessional contributions cap, particularly where members receive contributions above the minimum SG rate.

Our Defined Benefit Division and Accumulation 2 members typically receive a 17% employer contribution. Members have no capacity to influence to the contribution rate because it's a fixed contribution rate to meet the funding of the DBD. As a result of reducing the concessional cap, more of our members are going to exceed the proposed $25,000 cap.

On two previous occasions when the concessional caps were changed, special grandfathering rules were introduced by former Treasurers Costello and Swan:

Given the unique nature of defined benefit schemes, and the difficulty for members to reduce their contributions, a transitional arrangement will apply to members of these schemes. Existing members of defined benefit schemes…with notional contributions above the concessional contribution cap will be deemed as having contributions made at the maximum level of the cap for the individual. This arrangement will no longer apply if the scheme amends their rules to increase member benefits.

Treasurer Media Release No 093, 5 September 2006

'Grandfathering' arrangements will apply to certain members with defined benefit interests as at 12 May 2009 whose notional taxed contributions would otherwise exceed the reduced cap. Similar arrangements were applied when the concessional contributions cap was first introduced.

Budget Paper No 2, p 35, 12 May 2009

The policy basis for grandfathering (i.e. it is difficult or impossible for members to reduce their contributions) has not changed. Members who join a defined benefit scheme between 12 May 2009 and 3 May 2016 are currently not grandfathered; however, consideration should be given to grandfathering them at the cap that they were subject to at the time of the announcement.

For this new category of grandfathered members, for any notional tax contributions (NTCs) in excess of the cap (i.e. $35,000 for older members or $30,000 for those under 50 years of age), only the NTC amount above the grandfathered cap would be subject to marginal tax rather than the excess over the proposed general cap of $25,000.

This policy would ensure that those who joined defined benefit schemes between Budget nights 2009 and 2016 would be grandfathered on terms similar to those grandfathered under previous announcements.

Comments on catch-up concessional contributions

The policy to allow catch-up concessional contributions is to be welcomed. It addresses a number of problems faced by members with broken work patterns and longer term consideration should be given to allowing all members, regardless of the size of their account balance, the opportunity to make catch-up contributions after having been out of the workforce.

Proposed section 307-205 is confusing and potentially requires defined benefit interests to be valued annually based on the valuation factors in Schedule 1B of the Income Tax Assessment Regulations 1997. Currently, this calculation is only done once under the "proportioning rule" when a defined benefit pension becomes payable.

There is a simpler alternative approach using the existing Member Contribution Statement process. Question 58 requires funds to report an account balance to the ATO based on a member's withdrawal benefit as at the last reporting date.

We submit that this approach should be followed with additional rules around the exception for those funds unable or not legally required to report an account balance to the ATO in this manner.

Proposed sections 307-205 and 307-230 use the expression "at a particular time". This is an undefined and potentially confusing expression and we suggest replacing it with "end of financial year" or similar wording. We also seek confirmation that the $500,000 threshold will not be applied at a point in time when a member's total superannuation balance is potentially unknown; instead, that the ATO will be in a position to confirm to taxpayers their eligibility to make catch-up contributions and over what period they will be eligible – essentially a "green light" to make catch-up contributions without fear of exceeding the threshold.