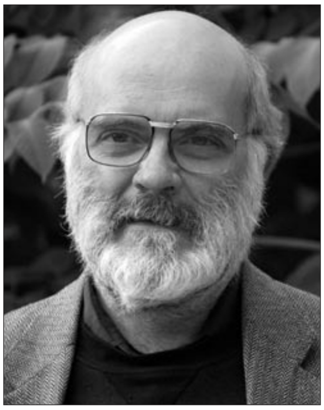
Self-managed allocated pensions: public policy issue

The package of Simplified Superannuation reforms implemented on 1 July 2007 has enhanced the attractiveness of allocated pensions as a vehicle for wealth holding and wealth management. However, further significant growth in the numbers of self-managed superannuation funds is likely to generate some perplexing public policy issues, which it might be useful to consider sooner rather than later.



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THE AUSTRALIAN GOVERNMENT'S Simplified Superannuation reforms can be expected to increase the popularity of allocated pensions among Australians over the age of 60 and those nearing that age. The already-growing popularity of self-managed superannuation funds (SMSFs) might reasonably be expected to interact with this. Add in the effects of an ageing population (increasing numbers of over-60s relative to the under-60s), and the outlook appears ripe for substantial growth in the numbers of self-managed allocated pension funds in Australia. With that will come an increased workload for the regulator of these funds, the Australian Taxation Office (ATO). If left unchecked, these processes will generate some perplexing public policy issues. This paper includes some suggested policy initiatives to pre-empt the development of potentially significant public policy problems.

Allocated pensions in the evolution of superannuation

The term 'allocated pension' has been used in Australia since the early 1990s to broadly describe decumulation wealth-management vehicles with the following characteristics: no longevity insurance; full flow-through exposure to the earnings rate on the funds-under-management; and flexibility in the size of drawdown payments made to the client during the decumulation period. For superannuation purposes, it is necessary that the product in question also qualifies for the income tax preferences accorded to superannuation pensions/superannuation annuities in Australia.

Over the past two decades, there has been a gradual liberalisation of policy on what types of retirement payout arrangements qualify as complying pensions and complying annuities such that earnings on fund-holdings standing behind the payout commitments continue to be tax-free. Until the 1993 reforms, incorporation of longevity insurance (i.e. the payment stream would continue to flow until the 'pensioner' died even if this was at a date substantially later than the life-tables had forecast) was required. Together with favourable income tax treatment of the pension and the two-tier RBL system, incentives were provided for citizens to take their superannuation end-benefits in ways which constrained the early dissipation of accumulated principal and locked-in prudently managed longevity insurance cover. From a public policy perspective, this can be viewed as representing appropriate *quid pro quo* to be borne by the direct beneficiaries of the superannuation system's tax-preferences, with a view to reducing the probabilities of those same persons needing further significant transfusions of resources from the remainder of the community's taxpayer base during their retirement years.

The 1993 changes reflected the fact that retirees were not sufficiently taking their superannuation benefits in the form of income-streams rather than in lump-sums despite the introduction of lump sum taxation in 1983, the 15 per cent rebate on complying pensions and the two-tier RBL scale. Giving some defined sort of 'flexible' income stream products the same taxation treatment hitherto reserved for complying annuities/pensions was expected to entice at least some retirees away from the lump sum option towards the 'income stream' approach.

The Dawkins package provided an authorised 'corridor' for superannuation decumulation contract arrangements. Provided drawdowns were beneath the 'ceiling' time-path prescribed and above the 'floor' time-path prescribed, earnings on the investment funds supporting the contract would be tax-free. But without longevity insurance, such a contract would not qualify as a complying annuity/pension for RBL purposes. This system has proved popular among large numbers of Australian retirees over the course of the past 15 years, but 'simplicity' is unlikely to have been its most powerful selling point.

During the past two years or so, the allocated pensions market has been given a further boost by the Government's adoption of a more lenient and flexible approach to the distinction between the accumulation phase of an individual's participation in the superannuation system and the decumulation phase of that individual's participation. Older Australian workers may now be quite open about having some of their superannuation savings in a decumulation vehicle, with the earnings on those monies tax free in the hands of the fund, while at the same time accessing taxation preferences associated with having further flows of superannuation contributions going into accumulation vehicles (where, however, the fund earnings are subject to tax at the 15 per cent rate). They can also do this without having at some stage 'retired from employment', and then subsequently (after some appropriate period) changed their mind.

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Simplified Superannuation and allocated pensions

The superannuation reform package announced by the Treasurer in May 2006, and now being implemented, seems highly likely to further enhance the popularity of allocated pensions for three reasons.

Firstly, since 1 July 2007, a zero income tax rate on pension payments applies where the recipient fund member is 60 years of age or above. This gives an incentive for those at or above 60 to shift their superannuation savings from being subject to accumulation phase tax treatment to become subject to decumulation-phase treatment. Under the latter there is zero tax on fund investment earnings in the hands of the fund, and zero tax on the payout monies in the hands of the recipient. If the person's preferences are against dissipating the payout monies, these can be paid back into an accumulation-phase superannuation-fund holding as either a deductible or a non-deductible contribution. Even among those between 55 and 60, the conversion of funds from accumulation to decumulation phase may be to an individual's advantage, depending on the arithmetic of any available re-contribution strategies under that individual's circumstances.

Secondly, abolition of the Reasonable Benefit Limits (RBLs) system removes the tax advantages (for those with more substantial superannuation balances) from taking at least half of their end-benefits in the form of income-streams that minimised the risk that the income-stream would 'dry-up' in value at some point prior to their death. It would appear that many Australians would prefer to shoulder the risks associated with the more 'flexible' allocated pension products than pay the actuarially fair price that is associated with a prudently managed commercial pension provider accepting to take over those risks. Alternatively it might be that they see it as preferable that any benefits from shorter-than-anticipated longevity and/or better-than-expected investment returns should go to their heirs while any costs from longer than anticipated longevity and/or lower than expected investment returns should be borne by the remainder of the community taxpayer base.

Thirdly, the removal of the 'authorised corridor' requirement for allocated pensions and elimination of any 'ceiling' on the amount per period that can be paid out (together with the tax-free status of the payout in the hands of the allocated pension holder) removes any constraint on rapid rundown/early dissipation of the funds. The continuation of lower limit requirements for each year's total payouts from an allocated pension allows the vehicles to be described as belonging to the decumulation class of superannuation vehicles. However, for the younger of the fund members, the floor payout rates required are set very low and could be effectively backwardised via a suitable re-contribution strategy. The bottom-line is that the 'allocated pension' has become yet more flexible as a vehicle for obtaining tax-advantaged income tax treatment on a portion of one's wealth holdings.

Self-managed allocated pensions and public policy

It has been argued above that the 2006–07 reforms will (a) encourage increased concentration of household wealth as superannuation, with (b) more held in vehicles enjoying decumulation-phase superannuation tax-treatment, and (c) will encourage increased use of 'allocated pensions' in the decumulation phase. Together with the current (or possibly increased) popularity of self-management of super there will be a substantial growth in the number of self-managed allocated pensions in Australia and in the volume of self-managed allocated pension paperwork required to be managed by the fund trustees, and in the volume of paperwork required to be lodged with the relevant regulator, the ATO. The Simplified Superannuation package increases the regulatory levy on SMSFs from $45 to $150 per year, and imposes a requirement that a 'Trustee Declaration' be signed and lodged with the ATO by all new trustees appointed after 30 June 2007. While those measures might serve to provide some element of discouragement to self-management, the package simultaneously promises to streamline reporting requirements from three forms to one for post-July 2008 reporting.

Most of the media discussion of the pros and cons of self-managing either some or all of one's superannuation in Australia seems to take place with a focus on the accumulation-phase context. And that discussion appears to boil down to two strands: one focuses on the explicit pecuniary costs, cost-savings and benefits associated with the self-management mode as compared with leaving things at arm's length with one or more APRA-regulated funds; the second focuses on the non-pecuniary or 'psychic' benefits and costs of bearing responsibility for various decision-making, record-keeping and compliance tasks inside the family-unit, as compared with having these pleasures and displeasures borne by 'strangers' (or 'agents').

Two messages appear to emerge from this discussion. Firstly, there is some minimum effective scale for an SMSF. There is a divergence of views as to what the dollar figure of this is, and it varies with the productivity (and opportunity costs) of the fund members' own labour that is applied to the self-management tasks. Yet, it is unanimously accepted that below some figure for the value of assets in the fund, self-management is a recipe for burning up resources. Secondly, there is a need for at least one of the four or less members of the SMSF to have sufficient enthusiasm and disciplined self-application to ensure that the trusteeship duties are fulfilled on a regular basis and appropriately documented accordingly.

When it comes to making a decision to set up an accumulation-phase SMSF, the person(s) responsible for taking that decision will usually be able to take comfort from two things, when mulling over the two 'messages' described above. An accumulation-phase SMSF, by definition, should rise in the value of its asset-holdings over time (even if not monotonically). Hence if scale-viability is 'borderline' at the outset, but not substantially worse than borderline, this might be expected to be self-correcting over time. Secondly, with an accumulation-phase SMSF, the 'prime-mover' self-manager is likely to be a person 'in the prime of life' who might be able to feel confident that if their skills and aptitudes for the trusteeship tasks required are 'borderline', these might be expected to improve after a few years of 'learning by doing'.

These two sources of comfort might be available to persons in their 50s or 60s contemplating establishing self-managed allocated pensions, provided they restrict their thinking to a relatively short future time-horizon. Objectively, it might seem reasonable to expect such persons to appreciate that: (a) a decumulation-phase superannuation fund will, at some stage, start to shrink in size and also (if its members do not die first) fall below whatever the appropriate benchmark then is for scale-viability; and (b) the processes of ageing and mortality among the fund-members might at some stage render the trusteeship tasks onerous for the surviving fund-member(s), but this might occur in a manner that makes it difficult for the self-manager to accept that this is the case until the trusteeship duties have already been neglected for a period. While *objectively* it might seem reasonable to expect that some heed be given to these two considerations, *realistically* it might be more appropriate to envisage that process more often than not concluding with the individual promising themself (and their spouse?) that these considerations will be properly revisited 'in the fullness of time' when they are no longer matters at such a great distance from the more tangible 'here and now'.

The removal of the 'ceiling' restriction in relation to drawdowns under allocated pension arrangements may serve as an encouragement to the establishment of self-managed allocated pensions by persons in their 50s and 60s who promise themselves that they will reconsider the longer-term future of their vehicle when that longer-term

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future is no longer so far away. Without the ceiling restriction, the process of implementing an exit from such a vehicle, at a time when it is judged appropriate to do so, is rendered more simple. So why worry about that right now?

But there is a potential problem. What if the ageing process, or the death of the 'primemover' member of a more-than-one-member self-managed allocated pension allows that self-managed allocated pension to drift past the point at which it would have been in the best interests of the vehicle's members to wind it up and either roll over into an APRA regulated vehicle, or take the remaining funds outside the superannuation system?

What might appear at first sight to be a problem simply of the members of such a vehicle might easily become a growing headache for the regulator of such vehicles, and for public policy. If the regulator starts to receive increasing numbers of annual returns from self-managed allocated pensions that are clearly well below any reasonable threshold for a viable scale and/or finds that increasing numbers of self-managed allocated pensions of small size are falling further and further behind with their paperwork, what is the regulator expected to do? In the latter case doing nothing might have some attractions as compared with the alternative of employing increasing volumes of regulatory resources to impose increased anxiety burdens on elderly persons who may already be in fairly vulnerable states.

Clearly, it would be wise from a public policy perspective to do something now about the framework for handling this potential problem, rather than wait for the numbers of persons affected by the problem to swell to significant proportions.

Conclusion

Here are some suggestions for ways of addressing the problem:

1. Define a minimum size of fund holdings for a 'viable' self-managed allocated pension (subject to appropriate annual indexation). Do not permit a vehicle to be established if it is not above that figure. Require either rollover into an approved APRA-regulated vehicle or removal of the funds from the superannuation system within a specified period of a vehicle's decumulating below that figure.

2. Where a trustee of a SMSF is older than some defined age (say 75?), require that a signed Trustee Declaration form be lodged annually and that it be supported by a signed statement from a medical practitioner certifying that it is compatible with the person's health status that they continue to shoulder the duties/responsibilities of trusteeship.

3. Require that the trust deed of each self-managed allocated pension contain clauses providing for an orderly winding-up of the vehicle, under the supervision of a defined outside party, under some specified 'triggering circumstances'. The idea is essentially that just as each APRA-regulated superannuation fund is required to designate an Eligible Rollover Fund (ERF) to take over management of the funds of a member where those funds are so meagre as to be in danger of turning to dust, an equivalent mechanism should be mandatory for SMSFs so small as to be in the process of turning to dust. Once such a mechanism was in place to deal with that contingency, it could be given additional triggers such as when the trustee has been unable to obtain a medical practitioner's certificate of the type described in (2), and/or when a vehicle's annual returns obligations have fallen some defined period in arrears and after specified reminder processes and time-extensions etc., have been exhausted.