Actuaries Institute.

11 October 2024

Tax and Transfers Branch
Retirement Income and Superannuation Division
Treasury
Langton Cres
Parkes ACT 2600

Email: superannuation@treasury.gov.au

Dear Sir/Madam

Consultation: Legacy retirement product conversions & reserves – Draft regulations

The Actuaries Institute (the Institute) welcomes the opportunity to make a submission to this consultation. The Institute is the peak professional body for actuaries in Australia. Our members have had significant involvement in the development and management of superannuation within Australia.

The Institute supports the proposal to remove obstacles to winding up legacy retirement income products and to create a more flexible avenue for allocations from superannuation reserves in the Treasury Laws Amendment Instrument 2024: Self-managed superannuation funds – legacy retirement product conversions and reserves (Draft Regulations). This would allow individuals, over a five-year period, to exit products that are no longer suitable for their circumstances, remove barriers that currently prevent the closure of self-managed superannuation funds (SMSFs) and small APRA-regulated funds (SAFs) when they are no longer suitable for the members, and allow for the allocation of reserves that no longer serve an ongoing purpose.

Introducing this flexibility would enable members with legacy products to rationalise their superannuation without compromising the integrity of the superannuation system. We are confident this would be welcomed by impacted members and would hasten the reduction in pension reserves in SMSFs and SAFs. While we believe these changes are highly valuable on their own, introducing them in advance of the proposed Division 296 tax would improve how amounts are attributed to fund members and taxed accordingly.

Clarifying the intent of the Draft Regulations

Our understanding of the Draft Regulations is that they have been drafted with the intention of allowing the following events in respect of legacy lifetime superannuation income streams in an SMSF or an SAF, and life-expectancy and market-linked superannuation income streams in any superannuation fund:

- Members with existing legacy pensions: The pension could be commuted in full and the entire balance supporting the pension reserve allocated to the member's accumulation interest, an account-based pension, or paid out of superannuation entirely, without this being assessed against the non-concessional contribution cap for the member. This would also apply to members in receipt of a reversionary legacy pension.

- Members who previously had a legacy pension where that pension has ceased and there was an amount left over in the reserve: The entire remaining balance of the reserve that previously supported that member's pension liability could be allocated to them (if they are still alive). It could then be retained in an accumulation account, used to commence an account-based pension (or another retirement income product), or paid out of the superannuation system entirely. Such an allocation would not be assessed against the non-concessional contribution cap for the member. This is also the intent where the member was a reversionary pensioner.
- A member with a legacy pension has died and there is an amount to pay on death: The amount of the pension liability due to be paid could be allocated from the reserve to the beneficiary of the reserve through new ITAR* sub-sections 292-90.02(5) or (6) replacing the current ITAR paragraphs 292-25.01 (5)(c)(i) and (ii). We note that subtle wording differences between ITAR paragraph 292-25.01(5)(c)(ii) and new sub-section(6)(d) would now risk precluding payment to the estate, by inclusion of paragraph (6)(d)(i).
- A member with a legacy pension has died, the pension is not reversionary, and there is an amount left over in the reserve: Amounts could be allocated from the reserve to a member of the fund and would be assessed against that member's non-concessional contribution cap, unless the "5% rule" applies.

** ITAR means the Income Tax Assessment (1997 Act) Regulations 2021*

We have provided this summary of our understanding of the intention of the Draft Regulations because, if you agree with this summary, it may help to guide the drafting of the final regulations, and our feedback on them.

In the following sections we provide our view on areas of the Draft Regulations which may benefit from additional consideration by Treasury. There are also some additional potential issues from a large fund viewpoint, which we have commented on in Appendix 2.

General observations

The regulations include a five-year period (rather than unlimited time) for commutations of legacy pensions. They also only provide relief for full (not partial) commutations. We consider these limitations reasonable.

> *Consideration 1*: The Draft Regulations would provide trustees with the opportunity to take action to commute legacy pensions, and allocate reserves, in advance of the proposed introduction of Division 296 tax from the 2025-26 financial year. We propose the final Regulations be implemented as soon as practicable, to allow advisers time to discuss and implement appropriate strategies for their clients. As explained in Appendix 2, a practical ATO reporting compliance approach may be required for any large funds that have affected reserve allocations underway at the time of implementation.

In contrast, the changes to how reserve allocations are treated for contribution cap purposes have no end date. We also consider this appropriate.

The change to permit amounts allocated from a reserve (where they do not meet the requirements to be excluded from the contribution caps) to count against the non-concessional contribution cap, rather the concessional contribution cap, is also welcome.

We acknowledge that:

- Some members have a non-concessional cap of nil, so every dollar allocated from reserves would be in excess of the cap.

- Members over / under 75 face different treatment (since only those under 75 at the start of the year can access the bring forward non concessional contribution cap rules).
- Generally, members would choose to remove allocations in excess of the cap (plus 85% of associated earnings) from the superannuation system. In some cases, the mechanics of this process would effectively force them to withdraw some of their own, existing, superannuation to avoid additional taxes.

Nonetheless, we believe the Draft Regulations generally represent a reasonable outcome.

The Draft Regulations do not include any changes to the operation of the transfer balance cap (TBC). For some members, the mechanics of the current provisions for debits to the TBC mean they do not have sufficient cap space to convert any of their legacy pension commutation amount to a new (replacement) pension (because the debit value does not free up enough cap space to do so). While undesirable for the members concerned, this is consistent with current law. However, it does present an opportune time to correct one known anomaly in the TBC legislation.

> *Consideration 2*: There is a known issue with the current law which results in an unintended outcome for individuals who are the reversionary recipient of a legacy pension. Normally, if a reversionary pensioner wishes to commute their reversionary pension in the twelve months after the date of death of the original pensioner, they receive a debit to their TBC account (for the commutation) and then a credit (for the inheritance of the pension) on the 12-month anniversary.
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> However, for legacy pensions, the debit on commutation is based on the credit that has 'arisen' as a result of the pension. Where a legacy pension is commuted within this 12-month period, no debit has yet arisen. This means the debit is nil but a credit still arises on the 12 month anniversary.
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> For members who may be looking to implement a full commutation of their reversionary legacy pension under these Draft Regulations a nil debit value could materially impact their ability to commence a new account-based pension with the commutation value. We believe this is an unintended outcome. A more equitable outcome consistent with the intent of the law in this situation would be for the credit used in the debit calculation to be that which would arise in the member's account at the end of twelve months. In our view, fixing this anomaly should be considered separately if it would delay the finalisation of the Draft Regulations.

We also note that many recipients of legacy pensions are receiving social security benefits and relying on the fact that their legacy pension is 100% or 50% Assets Test Exempt (ATE). We believe it is a reasonable outcome, consistent with current law, that this ATE is forfeited as part of taking advantage of this new opportunity to commute a legacy pension, and that any part of the commutation amount (or subsequent reserve allocation) remaining in the superannuation system is assets tested in full.

> *Consideration 3a:* It is important that an updated debt waiver instrument (i.e., similar to *Social Security (Waiver of Debts – Self Managed Superannuation Funds and Small APRA Funds) (DSS) Specification 2021* is implemented in tandem with these regulations to avoid commutations being subject to a 5-year claw back of social security entitlements.

We are concerned that the proposed amendments to the SIS regulations could result in existing ATE legacy income streams losing their ATE, even prior to any commutation allowable under the Draft Regulations.

Using lifetime income streams as an example, as one of the conditions for ATE subsection 9A (1)(a) of the Social Security Act 1991 (SSA) requires the income stream's governing rules to meet the requirements of subsection (2), which includes at subsection (h) the exceptions for when the income stream can be commuted. The Draft Regulations would introduce an additional exemption to the commutation restrictions in the SIS regulations which will not be specified in SSA subsection 9A (2)(h). We are concerned that, where a legacy income stream's governing rules incorporate the SIS regulations commutation restrictions by reference, those governing rules would no longer meet the requirements of the SSA section 9A and hence would cease to qualify for ATE immediately upon the SIS regulation changes taking effect, regardless of if or when the exit option was exercised. It is our assumption this would be unintended, and this anomaly should be fixed.

> *Consideration 3b:* Recognising that a change to the SSA may delay finalising the Draft Regulations, we propose that SSA subsection 9A(5) be investigated as an avenue to ensure ATE would be retained on existing ATE legacy lifetime pensions unless and until the exit option was exercised (or other action causes ATE to be lost). For example, a determination from the Secretary that income streams which would otherwise be ATE apart from the difference in commutation exceptions under SSA subsection 9A(2)(h) could continue to be an ATE income stream. Corresponding action would be required for ATE legacy pensions other than lifetime pensions.

Implementing the commutation of an existing legacy pension

The proposed SIS regulation 1.06C in our view effectively implements the desired intent to allow commutation of the whole benefit from a market-linked pension, lifetime pension or life expectancy pension. Together, SIS regulation 1.06C and ITAR sub-regulations 292-90.02 (1) - (4) and (7) implement the desired intent to allow full commutation from legacy pensions where the pensioner is still alive.

For members with a lifetime complying pension (SIS sub-regulation 1.06(2)) the commutation value, when commuted in full, could be the value of the pension reserve, and for a market-linked pension (SIS sub-regulation 1.06(8)) it would be the value of the pension interest. The process to exit these pensions under the proposed Regulations could be completed in one step.

For members with a life-expectancy pension (SIS sub-regulation 1.06(7)) there are two restrictions on the commutation value to comply with.

The first is contained in paragraph (i) of SIS sub-regulation 1.06(7) which states that "if the pension is commuted, the commuted amount cannot exceed the benefit that was payable immediately before the commutation". This commutation restriction is generally interpreted as meaning that the lump sum amount resulting from commutation cannot exceed the expected future pension payments over the remaining term of the pension.

The second commutation restriction is the SIS regulation 1.08 restriction, which limits the resulting lump sum to that calculated using the relevant pension valuation factor in SIS Regulations Schedule 1B.

Consequently, the commutation amount of a life expectancy pension would be the lesser of the two amounts calculated under each commutation restriction. It is not uncommon that this maximum commutation value is less than the value of the pension reserve. As such the exit from a life expectancy pension would be a two-step process under the Regulations. Firstly, a commutation of the pension, subject to the maximum commutable amount; and secondly, allocating the residual capital of the pension reserve to the member with such an allocation not being assessed for contribution cap purposes.

> *Consideration 5:* As the purpose of the Draft Regulations is to allow a member to fully exit their life expectancy pension, to reduce red tape, misunderstanding, and complexity in implementation, we would propose that the commutation restriction in paragraph (i) of SIS sub-regulation 1.06(7) and SIS regulation 1.08 be removed, or at least an exception introduced for commutations made in accordance with the 5 year exit option. This would allow the full value of the pension reserve to be the commutation value, removing the two-step process.

We would support removing the commutation restrictions of SIS regulation 1.08 altogether, which would also simply the process for a SIS sub-regulation 1.06(6) "flexi" pension which is also subject to the SIS regulation 1.08 maximum commutation value restrictions. The commutation of a "flexi" pension is not considered in the draft Regulations as they are already a commutable income stream. However, like the SIS regulation 1.06(7) pensions, the maximum commutation value is often less than the value of the pension reserve, resulting in a two-step process to exit in full. The removal of SIS regulation 1.08 would allow the full value of the pension reserve to be the commutation value, removing the two-step process.

Allocation from reserves

It is our understanding that members could choose to implement the provisions in ITAR 292-90.02 concurrently, and prior or current use of one provision would not prevent the use of another subsection in the same financial year.

Consideration 6: It would be valuable to confirm this intent for practitioners. For example, where a reserve is a pension reserve and currently supports payment of a pension liability to a member of the SMSF (and as such is utilising subsection (3) to discharge a pension liability in respect of an existing legacy pension) that allocation does not count towards the member's non-concessional contribution cap. Would the member also be eligible to allocate from the reserve under subsection (2), or make an allocation which would count against the member's non-concessional contribution cap?
Scenario: In a given year where a member is in receipt of an existing SIS regulation 1.06(2) lifetime pension, the trustee would make an allocation from the pension reserve to the pensioner to satisfy the annual pension payment liability which would not count against their non-concessional contribution cap, and could also make an allocation from the pension reserve to the pensioner which would count against their non-concessional contribution cap.

Additional contribution cap-free pathway for reserve allocations

The proposed ITAR sub-sections 292-90.02(4), (5) and (6) would provide a mechanism for allocating pension reserves without any assessment against the contribution caps under the circumstances outlined earlier.

However, they do not appear to provide a mechanism for a cap-free allocation pathway if, for example, the death of the primary pensioner simply causes the pension to cease (e.g. it is non-reversionary, and any guaranteed payment period has expired). It also provides no mechanism for leftover reserves to be paid to the deceased's estate – creating logistical challenges for those with no obvious beneficiaries who could join the SMSF.

Consideration 7: Given the Government's desire to see reserves fully allocated, we believe it would be beneficial to develop an additional pathway to allocate reserves – the "**death benefit allocation**" pathway. This could be provided in addition to the existing pathways under ITAR sub-sections 292-90.02(4) – (6) and permit posthumous allocations:

- From the reserve to the deceased member (with no contribution cap assessment), subject to the proviso that they are made as soon as practicable after death; and then
- To be paid as a superannuation death benefit (i.e. lump sum, not pension) to the usual range of beneficiaries and/or the deceased's estate, with the usual tax implications.

Examples to be included in the explanatory statement

Even for practitioners working within the specialised area of SMSFs, dealing with legacy pensions and reserves is seen as an area of great complexity where specialised knowledge is required. The explanatory statement accompanying the Regulations will be a valuable document for practitioners seeking to understand the new Regulations.

> *Consideration 8:* In our view, the complexity of this area warrants extensive use of examples in the explanatory statement. See Appendix 1 for some suggested examples.

Other considerations

We note that the Draft Regulations include permitting, during the grace period, the full commutation of certain annuities issued by a life company, including some types of lifetime annuities.

Based on the understanding that the proposed changes are intended to remove tax and regulatory consequences that could stand in the way of exercising product commutation capability, the restrictions of any individual product may continue to be an issue. However, product-specific conditions that restrict commutation should already be appreciated by the trustees having purchased that product.

The Institute would be pleased to be contacted in relation to any questions on this submission or to provide further detail on any of the areas covered. If you would like to do so, please contact the Institute via (02) 9239 6100 or public_policy@actuaries.asn.au.

Yours sincerely

(Signed) Louise Campbell
Deputy Chair of the Superannuation and Investments Practice Committee

Appendix 1: Example scenarios for the application of new regulations

We suggest the examples include the following.

Example 1

A member who is alive and is the primary or reversionary pensioner of a lifetime complying pension (SIS sub-regulation 1.06(2)) decides to commute in full their pension. The example should clarify that the full balance of the pension reserve can be allocated to the member's accumulation interest, or/and used to commence an account-based pension (subject to their transfer balance cap), or/and paid out of superannuation, under proposed SIS regulation 1.06C and ITAR 292-90.02 (4), and this does not count towards the non-concessional contributions cap.

Example 2

A member who is alive and who was the primary or reversionary pensioner of a lifetime complying pension (SIS sub-regulation 1.06(2)) which was previously commuted in full to commence a market-linked pension in the fund, and there remained an amount in the reserve post commutation. The example should clarify that:

- This reserve continues to meet the definition of a pension reserve.
- Amounts up to the full balance of the pension reserve can be allocated to the pensioner under proposed ITAR sub-section 292-90.02(4) and do not count towards their non-concessional contributions cap.
- Allocations from the reserve can occur even well after the original commutation date (including cases where the commutation occurred many years ago).
- The ability to make allocations under ITAR sub-section 292-90.02 (4) is not compromised by any historical practice such as making reserve allocations using the "5% rule" or concessional contribution caps.
- The full balance of the existing market-linked pension can be commuted to the member's accumulation interest, or/and used to commence an account-based pension (subject to their transfer balance cap), or/and paid out of superannuation, under proposed SIS regulation 1.06C and ITAR section 292.90.02 (4), and this does not count towards the non-concessional contributions cap.

Further examples

Similarly for the following scenario variations:

- A member who is alive and is the primary or reversionary pensioner of a life expectancy pension (SIS sub-regulation 1.06(7)) where the pension is commuted in full under SIS Regulation 1.06C and subject to SIS Regulation 1.08 / SIS sub-regulation 1.06(7)(i) and allocated from the reserve using ITAR sub-section 292-90.02 (4), and there remains a balance remaining in the reserve to be allocated per ITAR sub-section 292-90.02 (4). It would be helpful to clarify the process which may apply in the two phases. Similarly, an example could be included for a fixed term flexi pension (SIS sub-regulation 1.06(6)).
- A member who is alive and is the primary or reversionary pensioner of a life expectancy pension (SIS sub-regulation 1.06(7)) where the term of the pension expires with a balance remaining in the reserve, with the reserve balance to be allocated using ITAR sub-section 292.90.02 (4). Similarly, an example could be included for a fixed term flexi pension (SIS sub-regulation 1.06(6)).
- A member who is alive and was the primary or reversionary pensioner of a life expectancy pension (SIS sub-regulation 1.06(7)), which was previously commuted in full or expired, and there remained

an amount in the reserve, with the reserve balance to be allocated using ITAR sub-section 292.90.02 (4). The member may also have a market-linked pension in the fund which could also be commuted in full under SIS regulation 1.06(C). Similarly, an example could be included for a fixed term flexi pension (SIS sub-regulation 1.06(6)).

- A member who is alive and is the primary or reversionary pensioner of a flexi lifetime pension (SIS sub-regulation 1.06(6)) where the pension is commuted in full and allocated from the reserve using ITAR sub-section 292.90.02 (4), with a balance remaining in the reserve post commutation. It would be helpful to clarify the process which may apply in the two phases where the pension is commuted subject to SIS regulation 1.08 (if this regulation continues to apply), and with the remaining reserve balance allocated under ITAR sub-section 292.90.02 (4).
- A member who is alive and was the primary or reversionary pensioner of a flexi lifetime pension (SIS sub-regulation 1.06(6)), which was previously commuted in full and allocated from the reserve using ITAR sub-section 292.90.02 (4), and there remained an amount in the reserve, with the reserve balance to be allocated per ITAR sub-section 292.90.02 (4).
- An allocation from a reserve, which originally resulted from the commutation or cessation of a defined benefit pension, to a member who is not covered by the exemptions and which therefore counts in full towards the non-concessional contributions cap.

Appendix 2: Additional comments from a large fund perspective

Title of Draft Regulations

The inclusion of 'Self-managed superannuation funds' in the title of the Draft Regulations is somewhat confusing as the Draft Regulations do not restrict the changes to SMSFs.

> *Consideration 9:* It would reduce the potential for confusion if the title of the final instrument does not imply that only SMSFs are affected by it.

Exit option – Exclusion of certain products in defined benefit funds

Under the Draft Regulations, the five-year exit option would apply to full commutations of legacy lifetime, life expectancy and market-linked superannuation income stream products that:

- commenced prior to 20 September 2007; or
- were commenced as a result of a conversion of an earlier legacy product that commenced prior to that date; and
- for lifetime pensions and annuities, are not provided from a defined benefit (DB) fund (DB Fund Exclusion).

Hence, on our reading, as well as SMSFs, the exit option would apply to relevant pensions in SAFs and large APRA-regulated funds (large funds).

We strongly support the exit option being available to life expectancy and market-linked pensions in large funds and SAFs (as well as SMSFs).

We also strongly support the exit option being available to lifetime pensions in SAFs (as well as SMSFs).

At this stage we have not formed a view on whether it would be desirable for the exit option to extend to lifetime pensions in large funds (generally employer-sponsored DB pensions). We have noted the DB Fund Exclusion, which we suspect is aimed at excluding such pensions. However if their inclusion is open to consideration, we would be happy to consider it further and provide our views.

We have therefore confined our comments to the issue of whether the drafting of the DB Fund Exclusion would effectively exclude lifetime pensions in large funds. On this point, our understanding is that under the relevant part of the SIS regulations (i.e. for regulation 1.06), a DB Fund as defined in regulation 1.03 is a fund with DB liabilities relating to pre-retirees. If this is correct, the DB Fund Exclusion as drafted would not apply to a DB Fund whose only DB liabilities are current DB pensions.

As a consequence, we consider the DB Fund Exclusion as drafted would also mean that *DB lifetime pensions in a large fund would be eligible for the exit option if the only DB liabilities in the fund were current DB pensions*.

> *Consideration 10:* The Draft Regulations would require modification to exclude DB lifetime pensions in all large funds from the exit option.

Allocations from a reserve to meet employer contributions (large funds)

DB surpluses are sometimes used to fund employer contributions for employees in an accumulation section of a DB fund i.e. the contributions are credited to member accounts by allocations out of the surplus DB assets rather than being paid into the fund by the employer. A similar scenario sometimes arises where a reserve is created out of surplus DB assets left when the last DB member exits and is used to meet employer accumulation contributions for a period.

In both scenarios we understand that it is intended that such allocations to member accumulation accounts would currently be caught under ITAR section 292-25.01 and reported as concessional contributions, after gross-up in accordance with ITAR sub-section 292-25.01(6).

> *Consideration 11a:* We do not expect it would be intended to change the treatment of these allocations from concessional to non-concessional contributions, given they are made in lieu of employer contributions, however we query whether the Draft Regulations provide for continuation of the current treatment in the above scenarios.
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> *Consideration 11b:* We note there is a further scenario, similar to the above, where the employer has agreed to meet administration and/or insurance costs for accumulation members and those costs are met from DB assets or a reserve. We understand that in this sort of scenario, the costs met would generally be viewed under the current regulations as allocations from a reserve that are required to be apportioned to accumulation members and reported as concessional contributions. Again, we query whether the Draft Regulations provide for continuation of the current treatment in this scenario.

Allocations from a reserve relating to ex-DB members (large funds)

Surplus DB assets left after DB conversions to defined contribution (DC) benefits are also sometimes allocated to a reserve and distributed from the reserve to ex-DB members.

Currently these allocations are not counted as concessional or non-concessional contributions if they meet the '5% rules', or they are counted as concessional contributions if they do not meet those rules.

Under the Draft Regulations, we understand that such allocations would:

- not be treated as either concessional or non-concessional contributions if they meet either the 5% rules or the pension reserve allocation (to an ex-pensioner) rules; or
- be treated as non-concessional contributions if they do not meet either of those rules.

We support the proposed change, as there are circumstances where allocations higher than 5% may be considered appropriate to compensate members for the loss of their DB entitlements and the current treatment (as concessional contributions) can result in arguably quite harsh tax treatment.

We consider treating allocations higher than 5% as non-concessional contributions would provide a fairer outcome in these sorts of circumstances. It would also be consistent with the policy intent as these sorts of allocations usually occur in conjunction with a compulsory DB-DC conversion as the employer seeks to exit what may reasonably be regarded as legacy DB obligations.

> *Consideration 12:* We note the more lenient treatment as non-concessional contributions could create some risk of gaming where there are a small number of selected members receiving allocations. We think there is a reasonably low risk of this given the process and parties involved in DB-DC conversions, however if considered necessary, provisions could be added to mitigate such risk – for example, treatment as non-concessional contributions could be confined to allocations that meet the 'fair and reasonable allocation under 5%' rules, other than the limitation to under 5%.

Timing and implementation – changes to treatment of allocation from reserves

The final regulations are proposed to be made with immediate effect.

We support the Regulations being implemented as soon as practicable for the reasons discussed in Consideration 1. However, we note that:

- if the regulations mean changes are required to large funds' treatment and reporting of some allocations from reserves, transitional arrangements would be required for affected funds to update their systems to align with the new requirements and to re-report where required; and
- member communications would be required if the treatment changes and members' decisions may be affected e.g. in relation to additional contributions. Members may also need time to obtain financial advice in relation to the impact on their personal circumstances.

To put the above issues into perspective, we would expect a relatively small number of large funds to have reserve allocations in progress, or with plans to take effect in the short term, at any particular point in time. If the treatment of accumulation account employer contributions (or administration or insurance costs) met from reserves or DB assets do not change, we expect that would significantly reduce the number affected and the implementation effort.

> *Consideration 13:* The Government should arrange for the ATO to adopt a facilitative compliance approach to any fund reporting that is delayed or needs to be re-reported due to changes in the treatment of allocations from reserves.
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> *Consideration 14:* We also request that the final explanatory material provide clarity as to the application of the changes to a particular reserve allocation in the financial year in which the change takes effect:
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> - We query whether this is based on the effective date at which the allocation is made to the member's account; and
> - We query whether eligibility for the 5% rule (under both ITAR regulation 292-25.01 for the time it applies and ITAR regulation 292-90.01 for the time it applies) is based on total allocations across the whole financial year.