Actuaries Institute.

26 April 2024

Retirement, Advice and Investment Division
Treasury
Langton Cres
Parkes ACT 2600

Email: superannuation@treasury.gov.au

Dear Sir/Madam,

Consultation: Better Targeted Superannuation Concessions: draft regulations

The Actuaries Institute ('the Institute') welcomes the opportunity to provide feedback on the draft regulations titled *Inserts for Treasury Laws Amendment Instrument 2024: Better Targeted Superannuation Concessions* and Explanatory Statement which are intended to support implementation of changes to reduce the tax concessions for individuals with higher superannuation balances.

The Institute is the peak professional body for actuaries in Australia. Our members have had significant involvement in the development and management of superannuation in Australia, and work across APRA regulated funds, SMSFs and public sector funds.

The Better Targeted Superannuation Concessions package proposes an additional 15 per cent tax on the earnings on superannuation balances that exceed $3 million. This would be legislated via insertion of a new Division 296 within the Income Tax Assessment Act 1997 (the **Division 296 Tax**).

As we outlined in our submission to Treasury on the draft legislation implementing this measure, the Institute reiterates its support for initiatives such as this measure that aim to reduce superannuation tax concessions so that the retirement income system is more sustainable and equitable. Accordingly, we support the intent to ensure that defined benefit (**DB**) interests receive commensurate treatment under the Division 296 Tax measure.

We note our continued concern with certain design elements of the Division 296 Tax in the bill introduced into parliament (and referred to the Senate Economics Legislation Committee), notably the precedent introduced by the taxation of unrealised capital gains and the proposal not to include any indexation of the $3 million threshold. Given the strong opposition that many stakeholders continue to raise with Government on the Division 296 Tax design, we recommend Government consider incorporating a statutory post implementation review clause in the broader legislation after an initial period following commencement (for example, after 2 years).

General comments on the draft regulations

The Institute broadly supports the approach proposed by Government to calculating the Division 296 Tax for DB interests. Recognising that any prescribed approach would not be fair to all individuals under all circumstances, we believe Government has in many areas struck an appropriate balance between designing for simplicity and ensuring the calculation sufficiently caters for the considerable variability in the design of defined benefit arrangements in both 'growth' (non-retirement) and retirement phases.

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The Institute strongly supports the proposal to adopt a simplified calculation to use the Vested Benefit Method (the **VBM**) for certain DB interests applicable to members considered highly unlikely to incur Division 296 Tax. As compared to applying the Family Law Method (the **FLM**), this simplification is likely to significantly reduce the compliance cost for eligible DB funds and sub-funds.

The Institute also strongly supports the Government's decision to maintain the existing methodology for determining Notional Taxed Contributions (**NTCs**) and defined benefit contributions, given the larger compliance cost implications and disturbances that changing this methodology would have caused to the much broader cohort of 'growth' phase members in DB funds and sub-funds beyond those directly impacted by the Division 296 Tax.

We also note the proposal for Alternative Valuation Methods (**AVMs**) where a superannuation actuary may issue a certificate if requested to do so by the trustee of the fund. At this stage we are supportive of this proposal intended to provide flexibility for trustees to adopt a valuation method that can reduce the costs of complying and administering the Division 296 Tax. However, the Institute believes further guidance is warranted to give sufficient statutory protection around the circumstances where this approach can be used.

As stated in the Explanatory Statement to the draft regulations, the current Family Law (Superannuation) Regulations containing default valuation factors and methods of calculation are due to sunset on 1 April 2025 and will be remade. We urge that the revised default valuation factors and calculation methods are released on a targeted basis no later than the end of the 2nd quarter of 2024. This timing would enable orderly implementation including sufficient time for superannuation actuaries to assess and recommend changes to scheme-specific Family Law factors, or develop AVMs where appropriate, along with six months for the necessary system changes. We note that there are only a small number of DB superannuation fund administration firms/systems, some dealing with hundreds of defined benefit category designs, which will be facing a significant amount of system changes to configure Family Law or AVM calculations effective 1 July 2025.

In the remainder of this submission in the Attachment, we focus on elements of the draft regulations where we consider the approach or drafting could be improved to better meet the policy intent and/or reduce complexity and associated compliance costs.

Given the time available, we have covered some issues at a high level. 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) Tim Jenkins
Chair, Superannuation and Investments Practice Committee

Attachment: Specific comments on the draft regulations

Potential for unfair outcomes

The proposed Family Law method for valuing DB interests necessarily uses group (rather than individual member) assumptions. As a result, there are some circumstances (for example, the member's exercise of an option such as early retirement or receiving 100 per cent of their benefit in the form of a pension) that would result in a jump in the Division 296 DB value. Where the Total Superannuation Balance (**TSB**) of that member would then exceed $3 million and the increase in value would be deemed as investment earnings, this outcome may reasonably be considered unfair by an individual who had intended to retire early and/or take 100 per cent of their benefit as pension, as there is a reasonable argument that their benefits were previously undervalued by the group assumptions.

In these circumstances, it might be appropriate to treat this difference as a contribution so that the difference arising from the member's exercise of an option is not deemed as investment earnings.

Similar arguments can be made in favour of excluding the impact of changes in DB interest valuation methodology or assumptions, which capitalise into a single year the change in value of a benefit accrued over many years (including years in which the member's TSB did not exceed the $3 million threshold).

However, we acknowledge that addressing all of these issues to improve fairness to DB members impacted by these scenarios would add considerable complexity to the overall approach.

Treatment of self-insured benefits

Some DB funds still have self-insurance arrangements. The regulations should ensure that where a benefit is paid for income protection (**IP**) or total and permanent disability (**TPD**), any self-insured component is treated as a contribution in the Division 296 earnings formula, so that DB members are not disadvantaged where they are covered under self-insurance rather than external insurance arrangements.

Proposed VBM

- **Conditions for VBM**: In relation to draft subsection 307-230A.07(1):
  - Condition (a) for calculating the total superannuation balance value using the VBM seems to be unworkably restrictive as (on our reading) it requires that the rules do not permit *any* superannuation interest in the *fund* to support a superannuation income stream. Most private sector DB funds (and sub-funds) have accumulation interests as well as DB interests and many DB members have accumulation interests in addition to their DB interests. It would be rare for a DB fund or sub-fund not to also offer accumulation benefits and account-based pensions. This drafting would therefore unintentionally exclude all or most lump sum DB interests as they would be in funds that offer account-based pensions.

    Further, it would not be uncommon for a DB fund or sub-fund to have DB members with lump sum only DB entitlements and other DB members (in different benefit categories) who have DB pension entitlements. We see no reason why the simpler and lower cost vested benefit method should not apply to the members of those funds who have lump sum only DB entitlements.

    We recommend draft subsection 307-230A.07(1) be modified to ensure the test in condition (a) only excludes DB interests that have DB pension entitlements. We would also recommend that this subsection be reviewed to ensure that a DB interest is not inadvertently excluded because it is able to support a non-lifetime income stream payable on total and permanent disablement or on temporary total disablement, taking into account the amendments to the definition of superannuation income stream in Section 307-70.02 made by *the Treasury Laws Amendment (2022 Measures No. 4) Act 2023*.

- The requirement for this subsection to be met for the VBM is provided for in subsection 307-230A.01, which refers to a 'defined benefit interest'. We understand this to mean that references to 'superannuation interest' in Section 307-230A.07 are to be read as meaning 'defined benefit interest', so that, for example, 'vested benefits total' would exclude any additional accumulation balances of a DB member. We recommend for this link to be made clearer in the regulation and/or Explanatory Statement, such as by using the term 'defined benefit interest' rather than 'superannuation interest' throughout Section 307-230A.07.
- We think the meaning is clear but note that in draft sub-section 307-220A.07(2) the grammar of the sub-paragraph numbering appears to have gone awry. We suggest part (b) should read "the individual became entitled…"

- **Reference to accounting standards**: In relation to determining the value of a non-public sector lump-sum-only interest at a particular time, the Explanatory Statement notes that the total vested benefit at the time is to be worked out in accordance with accounting standards in force at the time:
  - To avoid possible confusion where multiple accounting standards may not be strictly consistent, we recommend the Explanatory Statement clarify that this refers to the relevant accounting standard in force for superannuation entity reporting (AASB 1056).
  - Under AASB 1056 the assumptions used to determine the value of a deferred lump sum will vary between funds. If this is not considered appropriate for Division 296 Tax purposes, an alternative may be to require the value of a deferred lump sum to be determined using the relevant discount factor from Table 2 of Schedule 1B of the *Income Tax Assessment (1997 Act) Regulations 2021*. We think this will be the only element of the vested benefit of a lump sum DB interest that may require assumptions, although this issue may require further consideration for non-lifetime disability income streams.
- **Proposed $1 million threshold**: In relation to the proposed $1 million threshold below which specified DB interests would be eligible for the VBM, we understand that the rationale is to estimate the threshold below which there is very high confidence that members with these DB interests would not be liable to pay the Division 296 Tax. Based on the experience of our superannuation actuary members we would expect significant compliance cost savings from using the VBM as compared to the FLM. We therefore see merit in assessing whether the proposed $1 million threshold could be set at a higher level of $1.5 million. Given that most private sector DB funds have been closed to new entrants for some decades, the DB component of a member's total superannuation balance is reasonably likely to be significantly more than 50 per cent. We recommend that further analysis be conducted by Treasury based on relevant data from the ATO and/or APRA. If considered necessary, the higher VBM threshold could be accompanied by an additional VBM condition that the ATO has not advised the fund that the member's total superannuation balance at the prior 30 June exceeded (say) $2.5 million.
- **Lump sum only public sector DB interests**: In relation to the proposal to exclude lump sum only public sector DB interests from the simplified calculation, we recommend this be reconsidered with a view to enabling similar compliance cost savings for small public sector DB schemes, particularly in relation to schemes (or sub-categories of schemes) which have been closed for many years and have relatively small numbers of remaining members. We therefore suggest that the use of the VBM be extended to closed public sector scheme categories (providing lump sum only benefits) with membership below a nominated threshold.

AVMs

We note the proposal for AVMs where a superannuation actuary may issue a certificate if the actuary is requested to do so by the trustee of the fund.

At this stage we are supportive of this proposal intended to provide flexibility for trustees to adopt a valuation method that can reduce the costs of complying and administering the Division 296 Tax.

Our support is qualified as we do not yet have a view on how often AVMs are likely to be utilised for the Division 296 Tax. To issue a certificate, the actuary must be of the opinion that if the alternative valuation method is used, the value determined for each interest would be no less than 90 per cent (and no more than 110 per cent) of the value that would be determined if it was the family law valuation method that was used for those interests. While we understand the desire to limit this range, we suspect that in practice this constraint might be difficult to satisfy.

The Institute believes further guidance is warranted to give sufficient statutory protection around the circumstances where this approach can be used. There has been some industry concern that fund trustees may feel obligated by the best financial interests duty in Section 52(2)(c) of the SIS Act to engage a superannuation actuary to certify a method that results in values at the low end of the 90 to 110 per cent range. In the extreme, this could mean a method of setting the AVM formula specifying that values for all members are equal to 90 per cent of the FLM. While it is difficult to know how likely this scenario may be, we recommend that there be further guidance included in the Explanatory Statement around the circumstances in which a trustee may elect this option – for example, where the AVM utilises existing benefit calculations and the trustee is satisfied that the primary reason for using this method is to significantly reduce the costs of administering the Division 296 Tax in respect of fund members.

Update of notional contributions for DB interests

Proposed update of assumptions used to determine notional contributions for DB interests

- **Fund earning rate**: On the assumed fund earning rate which is proposed as 6 per cent p.a., we acknowledge there is a range of reasonable rates that could be considered. However, we believe there is a case that an assumed earning rate (and discount rate) of 6.5 per cent p.a. would better reflect current actuarial assumptions:
    - We understand that the proposed 6 per cent p.a. assumption had regard to APRA actuarial investigation data for recent years and investment objectives for balanced funds.
    - We sought information from two major actuarial firms about the results currently produced by the investment models they use to develop earning rate assumptions for actuarial investigations.
    - One firm advised that current projected earning rates for a balanced portfolio (in the range of 65/35 - 70/30 growth/defensive mix) are in of the order of 6.8 per cent to-7.1 per cent p.a., net of tax and fees, based on a duration out to 20-30 years (consistent with the long term appropriate for New Entrant Rate (**NER**) calculations). The other firm advised that the current projected earning rates from their model ranged from 6.7 per cent to 7.1 per cent p.a., net of tax and fees for a 65/35 - 75/25 split (for 20 years plus).
    - In terms of the suitability of using investment objectives as a basis for setting the earning rate assumption, we note that the expected investment return (discount rate) may be different to the "investment objective" a trustee will have chosen for a particular investment strategy.

- The chosen discount rate under the requirements of the actuarial valuations/accounting standards is the best estimate of future returns based on market conditions at the measurement date, having regard to the duration of the liabilities.
  - The investment objectives are neither a best estimate (i.e., 50th percentile or median) of future returns, nor are they necessarily reflective of market conditions for a given duration at a given moment in time. Rather, it is common for trustees to set a slightly conservative investment objective – perhaps the 30th to 40th percentile return (meaning the objective return is expected to be achieved 60% – 70% of the time over a given investment time horizon).
  - The duration for the liabilities and the measurement term for the investment objectives can also have a bearing on the difference between the two. Given that most DB funds have been closed for several years, it is also likely that the duration of liabilities will be lower than the longer-term durations which are implicit in NER calculations.
- **Exit and mortality rates**: We note the proposal to have separate exit rate tables for different retirement ages and separate pensioner mortality rates by gender. While we can understand that this might make the calculation more consistent with the FLM applied in relation to the Division 296 Tax, we are concerned this could unnecessarily complicate the valuation approach as:
  - Adding exit rates for a specific normal retirement age of 60, with age 65 to be used for all other cases, would appear to create anomalies with the treatment of other retirement ages different from age 65, such as the end of the month or financial year or calendar year after reaching age 60, or retirement ages around age 62.
  - Having separate pensioner mortality rates by gender would require male and female NERs for pension benefit categories (doubling the number of NERs to be dealt with and requiring re-configuration of administration systems, as well as adding complexity to the communication of new NERs to fund members). Alternatively, if it is intended that the specified male and female mortality rates be used to create a tailored set of unisex rates, we suggest further amendment would be required to make this clear, along with rules around how the blended rates would be determined. For example, should the blend be based on the mix of males and females who are DB members of the fund at 1 July 2025, or DB members who have pension entitlements, or DB members of each NER benefit category? Would the blend need to be reviewed in future and, if so, when?
  - Such refinements add complexity for what we expect to be a relatively small impact (taking into account rounding and other approximations). We note the vast majority of members are not expected to be liable for the Division 296 Tax, and for those who are, we expect any minor differences in the NTC rate would have a relatively small impact on the Division 296 earnings calculation (and likely be offset by an opposite impact on Division 293 Tax).

Recommendation

- For simplicity, we recommend Treasury retain the existing approach of using a single set of decrements and unisex pensioner mortality rates. We would suggest the unisex pensioner mortality rates be based on male mortality rates.

Grandfathering protection from NER increases due to changes in statutory assumptions

We note the intention, as set out in the draft Explanatory Statement, that increases in the NER that are a direct result of the amendments contained in the draft regulations would not disqualify a DB interest from grandfathered treatment. This is intended to ensure that grandfathered treatment continues to apply if the NER increased due to changes in *statutory assumptions* from legislating the Division 296 Tax.

We understand that the intent of the draft amendments is that the 'no increase in NER' condition for grandfathering after commencement would be based on whether there had been an increase in the NER *determined using the current Schedule 1A* (including the current statutory assumptions) rather than using the Schedule 1A to apply for NERs for 2025/26 and later years.

We are concerned that the draft amendments may add to compliance costs by requiring determination of the NERs on both the pre- and post-30 June 2025 bases. Further, we are concerned that the draft amendments would not always achieve their intended outcome. As NERs are rounded down to whole percentages, it is possible to envisage circumstances in which a minor benefit improvement may result in *an increase in the NER on the old basis and no increase on the new basis*, or vice versa. In our view grandfathering should only be lost in circumstances where an increase in the *actual NER* occurs as result of a benefit improvement (other than an improvement made to meet SG requirements).

We therefore submit that the draft amendments be recast so that the condition is based on *an increase in the actual NER* (rather than the current proposal for an increase in a notional NER determined on historical assumptions).

Grandfathering protection from NER increases due to changes in non-statutory assumptions

We strongly believe grandfathered treatment should also continue to apply if the NER increased due to changes in *non-statutory assumptions* arising from the most recent actuarial valuation of the fund, as changes in these assumptions that would increase the NER as at 1 July 2025 would not arise from any benefit improvement and would be outside the control of DB members. On our reading the current drafting does not allow for this.

More generally, we submit that loss of grandfathering due to an increase in NER should be confined to circumstances where an increase in the (actual) NER occurs as result of a benefit improvement (excluding, as currently, an improvement made to meet SG requirements) – that is, loss of grandfathering should never be triggered by a change in assumptions. We understand this was the original policy intent and request that the opportunity be taken now to update the regulations to make this clear. For clarity, this should extend to any changes of assumptions that occur following a Successor Fund Transfer (**SFT**), which can include the new entrant age determined in accordance with the regulations, in addition to assumptions used in the most recent actuarial valuation. We set out further details below.

Existing NTC Issues

The current regulations provide that grandfathering is lost when a member's new entrant rate increases unless the increase is due only to a change to satisfy Superannuation Guarantee requirements or a compulsory category change.

However, there are other reasons that could increase a member's new entrant rate without any improvement to the benefit the member is entitled to. The two main reasons are changes in actuarial assumptions and a change in the new entrant age in a SFT into an existing DB fund or sub-fund. In both instances we consider it would be unreasonable for members to lose grandfathering when there is no change/improvement to the benefits to which the members are entitled.

Key concern: loss of grandfathering due to changes in actuarial assumptions

The current regulations require the actuary to set any other assumptions not specified in the regulations but are necessary for the calculation of the new entrant rates. The regulations further provides that these assumptions are to be based on the assumptions used in the most recent actuarial valuation of the fund, unless the actuary believes these are no longer appropriate, in which case these assumptions should be set on a best estimate basis.

Changes in these actuarial assumptions to reflect actual or expected fund experiences could lead to higher new entrant rates, without any change or improvement to the benefits to which members are entitled. For example:

- Where a DB fund or sub-fund has pension benefits, an actuarial assumption is required on the proportion of members assumed to opt for a pension benefit as opposed to a lump sum benefit. When a fund experiences more and more members electing the pension option, the actuary may increase this pension take up rate assumption to reflect the fund experience and this may result in an increase in the new entrant rate.
- Where a defined benefit has a Minimum Requisite Benefit or other minimum benefit that is based on the accumulation of contributions plus earnings less expenses, an actuarial assumption is required for these expenses. A fund may experience a reduction in expenses due to the fund achieving cost savings in administration and insurance expenses, for example as a result of a fund merger. The actuary may reduce the expense assumptions to reflect the fund experience, which leads to an increase in the value of the minimum benefit and a possible increase in the new entrant rates. In such cases, the loss of grandfathering is a counterintuitive and unreasonable outcome for the DB members.

Recommendation

- The regulations should be amended to enable grandfathering to continue where there is an increase to the new entrant rate resulting solely from changes in actuarial assumptions (with no change in benefits).

Key concern: loss of grandfathering due to a change in the new entrant age on a successor fund transfer into an existing DB or DB sub-fund

The current regulations specify that the new entrant age is determined at the DB fund or sub-fund level. This means a single new entrant age is to be assumed for all the DB members in the fund/sub-fund.

One implication is that in a SFT into an ***existing*** fund/sub-fund, where the transferring DB members and existing DB members have different assumed new entrant ages, the transferring DB members may see a change in their assumed new entrant age. If this change is an increased new entrant age leading to increased new entrant rates, then the transferring DB members will lose grandfathering.

The current regulations provide that in cases of fund transfers, the actuary may recalculate the new entrant age taking into account the age at entry of the transferring DB and of the existing DB members. However, this recalculation could still result in an increase in the new entrant age and the resultant new entrant rates for either the transferring or the existing DB members, again leading to the loss of grandfathering.

This issue could be avoided if transferring DB members were in a separate sub-fund from the existing DB members. However, this requires the maintenance of two separate sub-funds with the associated higher fund management costs. This is an undesirable outcome and a hurdle to companies seeking to amalgamate their separate DB funds.

Recommendation

- In the case of fund transfers, the predecessor fund new entrant age for transferring DB members should be permitted to be maintained in the receiving fund.

Other concerns

- Part 5 of Schedule 1A of the *Income Tax Assessment (1997 Act) Regulations 2021* currently has the heading “Member has changed benefit category”. This heading is not consistent with the content of Part 5 which covers both a change of benefit category and an exercise of discretion. For consistency and clarity, we suggest the heading to Part 5 be amended accordingly.
- Part 6 of Schedule 1A has a potential timing issue where an amendment of the governing rules could be introduced in a particular financial year but only become effective in a future financial year. This issue can be resolved by amending clause 6.1(1)(a) from “… for a financial year in which there is an amendment of the governing rules (within the meaning of subsection 10(1) of the SIS Act) of the defined benefit fund that …” to “… for a financial year in which an amendment of the governing rules (within the meaning of subsection 10(1) of the SIS Act) of the defined benefit fund ***becomes effective*** that …”.