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Director's Note

Welcome to the twenty second issue of *Economic Issues*

Recent Issues Papers

21. “Australia’s Productivity Growth in the 21st Century”, by Dean Parham, September 2007.
20. “Building a Local Defence Industry: Workforce Requirements 2006-2010”, by Michael O’Neil, Steve Whetton and Edwin Dewan, March 2007.
19. “Running on Empty: The Risk of Continuing to Dither While the Empty Light is Flashing”, by Professor Peter Cullen, AO, Fv TD / , January 7.

Self Managed Superannuation Funds: Some Public Policy Issues Regarding Their “Decumulation” Phase

Overview

This paper argues that the 2006/07 package of superannuation reforms, together with certain pre-existing factors with which those reforms have interacted, will:

- encourage a greater quantum of Australian household sector wealth to be held within the nation’s superannuation system;
- encourage a greater proportion of the nation’s superannuation system assets to be held in vehicles enjoying *decumulation* phase superannuation tax-treatment; and
- encourage a shift within the range of available *decumulation* phase vehicles, in favour of those which have become known by the title “allocated pensions”.

Combined with the current degree of popularity for the self-management of super these factors will lead to a substantial growth in the overall quantum of monies in *decumulation* phase SMSFs in Australia, and in the volume of paperwork required to be managed by the trustees of those funds.

The paper then raises the question: What if the ageing process, or the death of the “prime mover” member of a more-than-

by entities other than life offices) have traditionally enjoyed access to the income tax preferences accorded to “superannuation” in Australia, provided they comply with the various other requirements that have been in place (and subject to evolution) over the years, including preservation, “no gearing”, the employment status of the client etc.

An “allocated pension” can be defined in the broad sense as the name that has come into use in Australia since the early 1990s to describe decumulation wealth-management vehicles which stand in the same relationship to the traditional life annuity as the “flexible” accumulation wealth-management vehicles discussed in the previous paragraph stand to the traditional whole-of-life life insurance policy. In other words, if you take a traditional life-annuity and (a) strip out of it any “life” insurance (or longevity insurance); (b) provide full flow-through exposure to the earnings rate on the funds-under-management; and (c) provide for flexibility in the size of drawdown payments made to the client during the decumulation period, what you are left with is an “allocated pension” in the *broad* sense of that term’s use in Australia. For the *narrower* sense, it is necessary that the product in question qualifies for the income tax preferences accorded to superannuation pensions/superannuation annuities in Australia.

Taxation in the Decumulation Phase

Until the 1988-89 round of superannuation reforms in Australia, there was no particular need to distinguish for taxation purposes whether the monies held in a particular superannuation scheme were standing behind that scheme’s responsibilities towards members who had started to receive pension drawdown payments, as distinct from monies standing behind the scheme’s responsibilities towards members still in the *accumulation phase* (whether in the status of contributory members or of non-contributory members who had not yet commenced drawdown). Either way, the investment earnings on those monies were income tax-free in the hands of the fund, provided the scheme met the various requirements for the tax preferences accorded to superannuation. And the annuity or pension payments received by decumulation-phase scheme members were subject to standard personal income-tax treatment in their hands, except for the tax-free u Tj 232.5 Ory or p 1Tj

Focussing back onto *allocated pensions* and their essential properties as outlined above, it would now seem reasonable to raise the question: If that is what an “Allocated Pension” is, why was the taxation status of wealth-management vehicles embodying those key properties so substantially enhanced during the John Dawkins round of superannuation taxation reforms of 1992-1993? There are probably two main ways in which that question might be approached. The first would be to argue as follows. (a) A set of superannuation arrangements is a means of dealing with a human-life-cycle-phenomenon. (b) This means there is typically a period in which income is earned by the individual from the supply of labour services, followed by a period in which the individual no longer earns income from the supply of labour

the contract would be the same as that applying where a longevity-insurance providing pension was being provided. But without longevity-insurance, such

“Simplified Superannuation” and Allocated Pensions

Under the superannuation reform package announced by Treasurer Costello in May 2006, three matters in particular would seem highly likely to further enhance the popularity of allocated pensions as a class of wealth-management vehicle for Australians. Firstly, there is the change in the tax-treatment of superannuation end-benefit payments received by decumulation-phase fund members over the age of 60. Secondly there is the ending of the RBL system, and with it the relative attractions that system provided to those with large stakes in the super system to opt for longevity-insurance-

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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(s)’ own labour that is applied to the self-management tasks, 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. ASIC, through its FIDO website, suggests an assets-level of \$200,000 for an SMSF to be “competitive” in cost terms with a low cost professionally-managed fund. It should be noted that according to ATO data, approximately 30 per cent of SMSFs have less than \$200,000 in assets. An ATO survey indicated that for SMSFs with assets less than \$50,000, operating expenses averaged 10.51 per cent of total assets.² 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 as thus.

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 will at some stage (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. Whilst *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 themselves (and their spouse?) that these considerations will be properly re-visited “in the fullness of time” when they are no longer matters at such a great distance from the more tangible here and now.

- (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 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 areas and after specified reminder processes and time-extensions etc., have been exhausted.

