FSC FINANCIAL SERVICES COUNCIL

Jenny Wilkinson
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PARKES ACT 200

Sent via email to: jenny.wilkinson@treasury.gov.au

Dear Ms Wilkinson

RE: Non-commutable annuities and the definition of 'capped defined benefit income stream'

The Financial Services Council (FSC) welcomes the opportunity to make a submission on issues with the definition of a 'capped defined benefit income stream' that was introduced by the *Treasury Laws Amendment (Fair and Sustainable Superannuation) Act 2016 (Act No. 81 of 2016)*.

Our comments are outlined in the Appendix and represent issues that mainly impact those FSC members that are life insurance companies that offer superannuation income streams in the form of a superannuation annuity.

We have identified a number of issues and detrimental impacts to annuitants based on the current definition of a 'capped defined benefit income stream'. Some of which are interpretational issues, whilst others we seek clarification as to the policy intent. We believe amending legislation is required to remove these potential detriment impacts, as well as addressing the inconsistent treatment and uneven playing field created amongst superannuation income stream providers.

Please do not hesitate to contact me should you wish to discuss further.

Yours sincerely

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Senior Policy Manager
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APPENDIX

General comments

The FSC understands the Government's policy around the concept of a transfer balance cap and the need to limit the earnings tax exemption afforded to assets supporting retirement phase income streams. It essentially requires a person in excess of their transfer balance cap to commute/withdraw the amount out of those income stream(s) as a superannuation lump sum, which could then be either rolled back to accumulation phase or taken as cash and out of the superannuation system. However there was recognition within the legislation that certain income streams are generally non-commutable and defined as a 'capped defined income stream' (CDBIS). Specifically, a person who has a CDBIS will not be required to commute/withdraw any excess transfer balance, but rather will be assessed on 50% of the regular payments that is in excess of the 'defined benefit income cap' (currently $100,000). We support this approach adopted for what are non-commutable superannuation income streams, as it provides for an alternate method to achieving the policy objective of removing the earnings tax exemption and provides the annuitant the ability to not disturb their regular payments from the superannuation annuity whilst addressing any excess transfer balance that could arise.

However the following matters listed below represent issues that our members have identified in relation to the current definition of CDBIS. They arguably give rise to detriments for recipients of certain annuity products and also creating inconsistent treatments amongst superannuation income stream providers.

We would welcome the opportunity to discuss these issues and to assist Treasury, including consulting on any proposed legislative amendments required based on our recommendations below.

Note: All subsequent references are to the *Income Tax Assessment Act 1997 (ITAA97)*, unless stated otherwise.

Strict satisfaction with the SISR definitions

Subsection 294-130(1) currently states that a superannuation income stream is a CDBIS if it is covered by an item in the table. Whilst the types of income streams outlined in column 2 of the table are commonly understood by superannuation income stream providers, column 3 actually requires a superannuation income stream to meet the particular standards set out within the sub-regulations of the *Superannuation Industry (Supervision) Regulations 1994 (SISR 1994)* in order to be a CDBIS.

Questions: We seek clarification as to what is the appropriate reckoning time for determining whether a particular superannuation income stream meets a particular SISR standard for the purposes of determining whether it is a CDBIS or not? Is it based on the facts and circumstances as at the commencement of the income stream or on 1 July 2017?

This point of clarification is important to life insurance companies given the tax treatment of some of its superannuation annuities will be a CDBIS if it existed prior to 1 July 2017, but not if it was issued on or after that date. But more importantly, certain annuities may contain a right under the contract that permits commutation within a finite window or under limited circumstances. Outside of this window or limited circumstances, the superannuation annuity is non-commutable.

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Questions: We seek clarification as to whether a superannuation income stream can meet or fail the definition of a CDBIS as the facts and circumstances change over time?

This point of clarification is extremely important given we believe the policy intent behind the concept of a CDBIS was to essentially capture superannuation income streams that are non-commutable.

We would submit that where a superannuation income stream permits a commutation within a finite window or under limited circumstances, and that particular window or opportunity lapses (as at reckoning time), then it should be considered non-commutable and therefore more likely going to satisfy the requirement of a CDBIS.

Notably the current exposure draft legislation containing technical corrections and minor changes to the superannuation reform package, released by Treasury for consultation[1] proposes to clarify (among other things) that assumptions about compliance with SISR rules and standards under which the superannuation income stream falls under will be based on only the facts and circumstances that exist at that time.

We would submit that this clarification on timing (of debits to transfer balance account for failure to comply with rules and standards) for the purposes of working out a person's transfer balance account is also required for the purposes of working out when a superannuation income stream is a CDBIS.

Recommendation: Insert a new subsection or subparagraph to section 294-130(1) which clarifies the reckoning time and that the determination is based on only the facts and circumstances at that reckoning time.

Inconsistent treatment of lifetime annuity vs lifetime pension

Subsection 294-130(1) currently states that a superannuation income stream is a CDBIS if it is covered by an item in the table. Essentially this includes income streams that are either lifetime, life expectancy and market linked. These typically will be offered by a complying superannuation fund or RSA in the form of a pension, or by a life insurance company in the form of a superannuation annuity.

Notably in relation to lifetime income streams, a lifetime pension will always be a CDBIS regardless of when the pension started, whereas in accordance with subsection 294-130(1)(b) a lifetime annuity will only meet the definition of a CDBIS if it was started before 1 July 2017.[2]

It is unclear to the FSC as to the policy intent behind this inconsistency, as we would regard having all lifetime income streams treated the same way from a tax perspective as greatly simplifying the administration of these income streams and better assisting the public in understanding this particular new measure. This inconsistency also creates an uneven playing field amongst superannuation income stream providers that offer lifetime income stream products. Specifically, a life company that wants to continue to offer a lifetime annuity from 1 July 2017 will need to at least allow for partial or full commutation within the contract, in the event the annuitant requests or the ATO issues a

[1] Refer to Section 294-50, Item 4 of Schedule 1 of the *Treasury Laws Amendment (2017 Measures No.2) Bill 2017* (the Amending Bill).

[2] See also paragraph 3.220 of the Explanatory Memorandum (EM) to *Treasury Laws Amendment (Fair and Sustainable Superannuation) Bill 2016* (the Bill).

commutation authority to the life company to withdraw an amount that is considered in excess of the annuitant's transfer balance cap. Introducing this flexibility places an undue compliance burden on life insurance companies to implement and communicate this change within the contract, as well as having both the systems and processes in place on 1 July 2017 to administer two separate books of lifetime annuities (from a tax perspective). But more importantly, this ability to commute a lifetime annuity at any time in the event of an excess transfer balance will change the pricing of these annuities. It is unclear at this stage just how much that will cost the person in terms of their potential income payments lost due to the notion of intermittent withdrawals. It should be noted that lifetime annuities that currently offer commutations, only offer it within a finite window or under limited circumstances (e.g. within a guarantee period and as a result of the death of the primary beneficiary). In other normal circumstances and under the contract, the withdrawal/surrender value that a person can reasonably expect to receive, even if they could voluntarily cease the lifetime annuity would be **nil**.

Notably the introduction of exceptions to commutation restrictions was also originally considered in the Exposure Draft of the *Treasury Laws Amendment (Fair and Sustainable Superannuation) Regulations 2017* (Regs), but was subsequently abandoned in the finalised Regs. Whilst the reason for not proceeding with this was not entirely clear, we believe the Minister had indicated that there were concerns with the potential for a person to fully commute what are non-commutable income streams. We would equally urge Treasury and the Government to stick with this policy objective and not disturb the product objective of a lifetime annuity which by its very nature is generally non-commutable and purchased with an intention of the annuitant to provide an income stream over their lifetime.

Accordingly, we believe all lifetime annuities should continue to be treated as CDBIS beyond 30 June 2017, as currently afforded to lifetime pensions. It should be noted that to not allow this consistent treatment, could give rise to an anomalous outcome and added administrative complexity for life insurance companies in situations whereby a lifetime annuity has been purchased by a Superannuation Fund Trustee in order to support and back the lifetime pension offered to their members.

Recommendation: Align the tax treatment of lifetime annuities to lifetime pensions within the definition of a CDBIS, and to always include a lifetime annuity regardless of when it started.

This could be achieved by replacing the reference to item '2' with '3' within subsection 294-130(1)(b).

Definition of 'maximum available release amount'

In the event the proposed recommendation above to align tax treatment of lifetime annuities to lifetime pensions is not accepted by Treasury or the Government, we wish to clarify just how a lifetime annuity issued on or after 1 July 2017 which say for all intents and purposes did not allow for any commutation whatsoever under the contract should be administered by the ATO. Firstly, it would not be a CDBIS under the current definition and therefore could potentially be subject to a commutation authority issued by the ATO if an excess transfer balance was determined.

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Specifically under section 136-80 of the *Tax Administration Act 1953 (TAA53)*, a superannuation income stream provider must, within 60 days after the commutation authority is issued, process a payment out of the superannuation annuity equal to the lesser of:

- the reduction amount stated in the commutation authority; and
- the 'maximum available release amount'.

Current definition of 'maximum available release amount' as prescribed within section 131-45 of the TAA53 states that it is the total amount of all the superannuation lump sums that could be payable from the interest at that time.

It should be noted that if a lifetime annuity did not allow for any commutations, then arguably the total amount of all the superannuation lump sums that could be payable from the interest **at that time** [emphasis added] and taking on the ordinary meaning of those words will be **nil**.

Questions: We seek clarification as to whether Treasury agrees that the maximum available release amount under this circumstance is nil? Furthermore, whether the life insurance company has still complied with the commutation authority?

Also, what is the consequence for the person with this lifetime annuity who has an excess transfer balance, but cannot withdraw any amount given the withdrawal/surrender value under the contract is **nil**?

If the intended outcome is that they will continue to have an excess transfer balance, then we would submit that the person is effectively trapped and as a consequence suffers detriment in this circumstance. Reason being, they would have no way to withdraw any amount from this lifetime annuity and with no debit to their transfer balance account to extinguish the excess (because it is not a CDBIS)[3], they will technically continue to incur excess transfer balance earnings and tax.

Recommendation: In order to avoid the quandary created, a debit in the transfer balance account to be provided where there is a non-commutable excess transfer balance, notwithstanding it is strictly not a CDBIS.

This could be achieved by explicitly including a further permitted scenario to subsection 136-70(1)(c) in Schedule 1 to the TAA53 being:

- the superannuation income stream is a non-commutable lifetime annuity.

NOTE: 1.We have not considered whether the lifetime annuity would also need to be subject to the capped defined benefit income cap taxation rules.

2. Interestingly, a similar set of circumstances arises where a market linked income stream (commonly referred to as a term allocated pensions -TAP) in existence prior to July 2017 is commuted to commence a new TAP after June 2017 .The new TAP is not a CDBIS but is nonetheless an essentially non-commutable income stream.(see the additional analysis at the end of this submission)

[3] Refer to item 7 of the table in subsection 294-80 of the ITAA97 in terms of a notice issued under section 136-70 in Schedule 1 to the TAA53 in relation to a non-commutable excess transfer balance.

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Substantially non-commutable lifetime annuities

Notably the current exposure draft regulation released by Treasury for consultation looks to expand the range of CDBIS. It is proposing to include lifetime pensions which do not meet the strict standards of subregulation 1.06(2) of the SISR 1994, due to the fact that among other things they allow for commutations under limited circumstances (such as during the first 6 months or during a guarantee period).

We would submit that some lifetime annuities offered within the market also do not strictly meet the equivalent standards of sub-regulation 1.05(2) of the SISR 1994 and for the very same reasons and circumstances. However they do in substance, meet the general standards of a lifetime annuity as set out in sub-regulation 1.05(11A) and specifically subparagraph 1.05(11A)(b)(iii) of the SISR 1994. Accordingly, we would urge Treasury to afford the same equal treatment to these lifetime annuities, as requiring commutation of these income streams may also equally not be appropriate (based on the concerns expressed earlier around their withdrawal/surrender value).

Recommendation: Align the tax treatment of substantially non-commutable lifetime annuities to substantially non-commutable lifetime pensions.

This could be achieved by inserting a new regulation 294-130.02 which recognises that an annuity issued in accordance with sub-regulation (11A) will also meet the standards of sub-regulation 1.05(2) of the SISR 1994, notwithstanding they are lifetime annuities that may only allow for commutation under limited circumstances.

Furthermore, we would propose that the valuation rules for these newly prescribed CDBIS should mirror the valuation rules provided to lifetime annuities.

Other non-commutable (non-lifetime) term annuities

The EM to the Bill both acknowledged and contemplated that additional superannuation income streams could be added to the definition of a CDBIS. Specifically paragraph 3.236 indicated that where it would be inappropriate to require individuals to undertake commutations then the regulations may also prescribe additional superannuation income streams as a CDBIS. An explicit example provided in the EM was where the fund rules, or **the contract** [emphasis added], do not permit commutation, or where the commutation value is unreasonably low when compared to the actual value of the superannuation income stream.

As mentioned earlier, in normal circumstances or where the annuitant is outside the permitted commutation window in respect of a non-commutable annuity, the commutation value could be limited to the remaining income payments within a guarantee period or even **nil**. We would submit that under these circumstances the person suffers detriment and should not be practically forced to commute what is primarily a non-commutable annuity, notwithstanding that it may have a fixed term ranging up to life expectancy.

Recommendation: All non-commutable or limited commutable (non-lifetime) term annuities to be included within the definition of a CDBIS.

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This could be achieved by explicitly including all these various types of annuities within the regulations as prescribed for the purposes of subsection 294-130(2) that is currently contemplated with the release of draft regulations to expand the range of CDBIS.

Market linked income Streams (or term allocated pensions (TAPS)

While having a clearly determined account balance, different (special) value rules apply to TAPS for Transfer Balance (TB) cap purposes.

Where a TAP was effected prior to 1 July 2017, it's classified as CDBIS and accordingly the relatively simple **"times**" valuation methodology applies to arrive at the value to be credited/reported to the ATO for TB cap and TB account purposes.

The concern is with the analysis that's to apply where a TAP in place at 30 June 2017 is subsequently commuted and the resulting proceeds rolled over to start a replacement TAP. The legislation in this regard is arguably somewhat unclear.

Questions: We would appreciate some clarification with respect to this issue.