ATTACHMENT 12 – REMOVING REGULATORY AND TAX IMPEDIMENTS TO THE PROVISION OF DEFERRED LIFETIME ANNUITIES IN AUSTRALIA

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REMOVING REGULATORY AND TAX IMPEDIMENTS TO THE PROVISION OF DEFERRED LIFETIME ANNUITIES IN AUSTRALIA

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EXTRACT

A discussion of the status of regulatory and tax arrangements which inhibit the provision of deferred lifetime annuities in Australia and the changes that are necessary to permit the provision of deferred lifetime annuities that are economic for both providers and policy holders. The paper examines the product features of deferred lifetime annuities and their appropriate treatment as longevity insurance. It considers the necessary arrangements to achieve competitive neutrality with other post-retirement pension products subject to the current favourable tax regime. The paper refers to the findings of the Final Report of the Review of Australia's Future Tax System in relation to deferred lifetime annuities and to subsequent decisions by government. These are relevant to the kinds of integrity measures which are necessary to ensure that policy holders' interests are protected and that the taxation and regulatory arrangements cannot be misused for purposes other than providing pension income, specifically tax deferral and estate planning.

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Why there are impediments to the provision of deferred lifetime annuities

Superannuation legislation is not high level and principles based. While there are many calls for it to be so, the difficulty is that given the concessional tax treatment of superannuation and the differences between tax treatment in accumulation and pension phase it is necessary to have some precise definitions to ensure that the tax treatment obtained is consistent with the true character of the products being taxed.

The Final Report of the Review of Australia's Future Tax System recommended halving the Earnings Tax rate and applying it to both accumulation and pension phase. This would have removed the need for many of the rules which establish the boundary between accumulation and pension phase, but that proposal seems to have found little support.

The search for one set of overarching rules is made more problematic by equity issues and the necessary widely different treatments of taxed and untaxed schemes, defined benefit schemes, account based products and various types of annuities.

There may be a common sense understanding of what a pension is, but given the risk that some providers will develop products that look like pensions but have as principal purposes deferring tax and estate planning, the definitions of what a pension is are likely to continue to be set out with some precision in superannuation and tax law. This ensures that tax concessions can be appropriately targeted and that the revenue is protected.

Within those constraints it is desirable that the definitions be carefully designed to allow for some innovation and wider product choice to facilitate taxpayers making provision for their retirement and retirees need for income from a range of products which, individually or in combination, allow them to manage the principal risks that they face. In retirement these are longevity, inflation and market risk.

For practical purposes the definition of an annuity is whatever is set out in superannuation and tax legislation. Deferred lifetime annuities have not been provided for, not because there was a policy decision to exclude them, but because they weren't contemplated either by policy makers or product providers at the various times revisions were being made to the SIS pension rules.

Deferred lifetime annuities are a risk product

A deferred lifetime annuity is an annuity which is bought on a date and commences to pay an income for life at a later date. As DLAs rely on the pooling of longevity risk they must be non-commutable to either the policy holder or their estate. As longevity insurance they are a risk product. Neutral treatment with other risk products would imply no Earnings Tax or Assets Test during the deferral period.

Relevant findings of the Review of Australia's Future Tax System

The need for longevity insurance and the treatment of DLAs was thoroughly canvassed in the Final Report of the Review of Australia's Future Tax System:

1. "The Review has also identified the role that deferred annuities can play in an ageing society. These products commence from a specified age and are a type of insurance against running out of income in retirement. " (page 543)
2. "...an allocated pension cannot ensure security of retirement on its own " (page 118)
3. "Products are not available in the market to cover the broad range of preferences of retirees in achieving security of income. This is a structural weakness in the Australian retirement income system. The main product on the market that does achieve this security of income is a guaranteed income for life...Given the diverse preferences of retirees, a single product is unlikely to satisfy all people who wish to manage their longevity risk. This suggests a need for product innovation within the Australian market." (page 118)
4. "The increasing life expectancies of Australians will require a greater choice of retirement income products that can cater for the different needs of individuals in retirement. There are not enough products that guarantee an income for the whole of a person's retirement."(page 120)
5. "Deferred annuities (overseas), which provide an income from a certain age, are also becoming more prevalent. These annuities allow a person to lock in part of their retirement savings to generate an income when they are entering the latter stages of their retirement. This provides a person with more certainty in how they manage the rest of their assets before the commencement of the deferred annuity." (page 123)
6. "...many people prefer to have the security of knowing they will always have an income above the Age Pension " (page 118).
7. "...given the unique nature of deferred annuities, there is a case that they should only be means tested when they start to pay an income, unless a person can access the capital before this time." (page 126)
8. "...the rule requiring a minimum payment to be made from a pension every year does not cater for deferred annuities." (page 119)
9. "The government should also consider removing other legislation constraints that may inhibit the development of longevity products. However, this should not be at the cost of necessary prudential or consumer protection. Given the nature of these products, they should only be provided by prudentially regulated entities. Products that provide a guaranteed income should follow consistent prudential requirements to reduce the risk that a provider is unable to meet their obligations as they fall due." (page 124)
10. "There should be no restrictions on people wanting to purchase longevity insurance from a prudentially regulated entity. This would be an important element in making it easier for people to purchase these products. " (page 116)
11. "People should be able to purchase these products with superannuation as well as non-superannuation money." (page 126)
12. "The restriction on people aged 75 and over making contributions should be removed. However, a work test should still apply for people aged 65 and over. There should be no restrictions on people wanting to purchase longevity insurance products from a prudentially regulated entity. (AFTS Recommendation 20)

13. "In many cases, people may choose not to purchase longevity insurance at their retirement age. As they grow older they may be in a better position to judge their potential longevity. However, after a person retires they may be unable to make further contributions into a superannuation fund due to the work test rules. These restrictions should not apply to contributions made to a prudentially regulated superannuation fund or life insurance company for the purposes of purchasing a longevity product. " (page 126)

Probably because the Review of Australia's Future Tax System recommended equalising the Earning Tax at 7.5% in both accumulation and pension phase it did not make specific recommendations on the Earnings Tax treatment of DLAs in the deferral period.

The impediments to the provision of deferred lifetime annuities

Until the Government's April 5 announcement and the Budget measure this year, both the tax treatment and the regulatory environment together, had effectively precluded any commercial offering of DLAs. There are 5 specific impediments which have resulted in DLAs not being provided as a post-retirement superannuation product:

1. The SIS definition of a superannuation pension does not include deferred lifetime annuities.

The consequence of this is that DLAs are not eligible for the Earning Tax and Benefits Tax exemption on pension products for persons over 60 years. This lack of tax neutrality is a major factor in not being able to offer a product which would be competitive in the Australian market.

2. Clarify the Earnings Tax treatment of non-commutable deferred lifetime annuities during the deferral period to explicitly recognise they are risk products.

The absence of DLAs from the definition of a superannuation pension has also resulted in an absence of legislative provisions for the Earnings Tax treatment of DLAs during the deferral period.

3. Clarify the accruals tax treatment of non-commutable deferred lifetime annuities to ensure that they can be bought either by an individual or by the trustee of a superannuation fund.

Currently the accruals tax regime provides anomalous treatment of DLAs. If an individual was able to buy a DLA in their own name they would not be subject to accruals taxation during the deferral period. If the same individual acting as trustee for an SMSF which only had themselves as a member bought a DLA, or if they bought a DLA as trustee of an SMSF with more than one member, or as trustee for a small or large APRA regulated fund, the trustee would be subject to accruals tax during the deferral period.

This is a function of the general accruals tax regime rather than a policy decision to provide different tax treatment between individuals and superannuation trustees. Removing the impediments to the provision of DLAs should include tax neutrality, that is no accruals tax during the deferral period, whether the DLA is bought by an individual or by a superannuation fund trustee.

4. Amend the APRA prudential standard on minimum surrender values so that non-commutable deferred lifetime annuities are not treated as investment products during the deferral period.

Until recently APRA Prudential Standard LPS 4.02 Minimum Surrender Values and Paid-Up Values treated DLAs as an investment product during the deferral period by requiring a surrender value. That rendered DLAs uneconomic by defeating the pricing that would otherwise be available using mortality credits. APRA Prudential Standard LPS 360 Termination Values, Minimum Surrender Values and Paid-up Values, issued in January 2013, would allow APRA to authorise DLAs with no minimum surrender value. The relevant section reads; "A life company must, before issuing a policy, obtain the written approval of APRA for the method of calculating the minimum termination value, minimum surrender value and minimum paid-up value if the policy does not belong to any of the types of business described in this Prudential Standard."

Deferred annuities in the deferral period are not covered elsewhere in the standard and therefore are subject to APRA approval. This is not a total solution but assuming APRA will recognise the need for non-commutability of DLAs this impediment has effectively been removed.

5. Non-commutable deferred lifetime annuities need to be exempted from the minimum drawdown rules during the deferral period.

The Final Report of the Review of Australia's Future Tax System said that, "the rule requiring a minimum payment to be made from a pension every year does not cater for deferred annuities." (AFTS page 119) A requirement for a DLA to provide a stream of payments to meet the minimum drawdown rules during the deferral period would render the product uneconomic. As DLAs are non-commutable the mischiefs that the minimum drawdown rules are designed to avert - tax deferral and estate planning - are dealt with without the need for annual payments in the deferral period.

Other specific issues raised in the Review of Australia's Future Tax System

The Final Report of the Review of Australia's Tax System raised two other issues, which are not by their nature impediments to the provision of longevity insurance but which would enhance the attractiveness of acquiring longevity insurance and extend the circumstances in which retirees could acquire products which provide protection against longevity risk.

a. Exempt non-commutable deferred lifetime annuities from the Assets Test during the deferral period.

This was proposed by the Review of Australia's Future Tax System and would provide consistent treatment with other risk products. The absence of an Assets Test during the deferral period would remove an objection retirees could be expected to have to buying longevity insurance in that they would lose some Age Pension entitlement on account of the premium but if they die early not receive any income from the DLA.

b. Remove the restrictions, including the work test, on the purchase of non-commutable lifetime annuities.

The Review of Australia's Future Tax System recommended (AFTS Recommendation 20) that, "There should be no restrictions on people wanting to purchase longevity insurance products from a prudentially regulated entity." The logic behind this recommendation was that; "In many cases, people may choose not to purchase longevity insurance at their retirement age. As they grow older they may be in a better position to judge their potential longevity. However, after a person retires they may be unable to make further contributions into a superannuation fund due to the work test rules. These restrictions should not apply to contributions made to a prudentially regulated superannuation fund or life insurance company for the purposes of purchasing a longevity product." (AFTS page 126) "People should be able to purchase these products with superannuation as well as non-superannuation money." (AFTS page 126).

Integrity Measures

The Review of Australia's Future Tax System proposed a number of integrity and consumer protection measures:

1. Products that provide a guaranteed income should follow consistent prudential requirements to reduce the risk that a provider is unable to meet their obligations as they fall due. (AFTS page 124) Given the nature of these products, they should only be provided by prudentially regulated entities. (AFTS page 126)
2. Only deferred lifetime annuities that are not commutable should be treated as pension products during the deferral period. (AFTS page 126)

Other Longevity Products

There are other longevity products which could be fitted into this policy framework, for example Ruin Contingent Lifetime Annuities. These could be in two forms:

1. The product provider manages a fund, the retiree is paid a given level of income and if the fund fails the product provider guarantees to provide a lifetime income stream.
2. The retiree buys longevity insurance which pays a lifetime income stream if a notional income drawn against a market index or composite of market indices fails. With this type of product there would be basis risk if the retiree invested their retirement savings in assets which did not reflect the relevant market indices.

Recent Government Announcements on DLAs

In the last three months the Government has announced policy decisions to remove the impediments to the provision of DLAs.

April 5, 2013 - Extending concessional tax treatment to deferred lifetime annuities

"The Government will encourage the take-up of deferred lifetime annuities (DLAs), by providing these products with the same concessional tax treatment that superannuation assets supporting income streams receive. This reform will apply from 1 July 2014.

The superannuation industry has called for this reform, including at the Government's Tax Forum in October 2011 and during meetings of the Government's Superannuation Roundtable.

This reform will have no financial impact over the forward estimates period."

2013 Budget Measure: Superannuation reforms — encouraging the take-up of deferred lifetime annuities

"The Government will encourage the take-up of deferred lifetime annuities by providing these products with the same concessional tax treatment that applies to investment earnings on superannuation assets supporting retirement income streams from 1 July 2014.

This reform will give retirees more choice by assisting those who wish to ensure financial security in their later years, by allocating part of their superannuation to a product that will provide an ongoing income stream beyond a certain age.

This measure is estimated to have no revenue impact over the forward estimates period.

A deferred lifetime annuity is an annuity that is purchased for an up-front premium but where payments do not commence immediately — for example, the product might be purchased at age 60 with payments commencing at age 80 and continuing for life.

The existing law requires that income streams must make payments at least annually. As a deferred annuity does not meet this requirement it does not qualify as an income stream, and therefore is not entitled to the associated concessional tax treatment that applies to earnings on superannuation assets supporting income streams.

This measure progresses a recommendation of the *Australia's Future Tax System* review and responds to calls to expand the range of superannuation options available to retirees.

This measure is part of a package of reforms to improve the fairness, sustainability and efficiency of the superannuation system. Further information can be found in the joint press release of 5 April 2013 issued by the Deputy Prime Minister and Treasurer, and the Minister for Financial Services and Superannuation."

Summary of the Government's policy position

These few paragraphs provide some important detail about the Government's decisions in relation to this important reform:

1. DLAs will be treated as pensions during the deferral period and the assets supporting them will be subject to the same tax treatment as the assets supporting other pensions, that is, they will be Earnings Tax exempt.
2. Pension income streams from DLAs will be exempt from Benefits Tax after age 60.

3. DLAs will not be subject to the minimum drawdown rules during the deferral period.
4. The measure will commence on 1 July 2014.
5. The measure has no revenue impact.

Together with APRA Prudential Standard LPS 360 Termination Values, Minimum Surrender Values and Paid-up Values, issued in January 2013, it can be concluded that these policy decisions remove the 5 impediments to the provision of DLAs. If there is no liability for Earnings Tax there will be no accruals tax on a superannuation DLA.

From the absence of any revenue impact it can be inferred that:

1. The measure relates to DLAs bought with superannuation money;
2. It is specifically focussed on longevity insurance bought at retirement;
3. There is no Assets Test exemption, which would have had some fiscal impact;
4. DLAs will not be commutable to an individual or their estate and are therefore a risk product. (If they were not a risk product, which also requires pooling, other pension structures would be likely to characterise accumulation as deferral with a significant impact on revenue); and
5. It seems likely that, for the purposes of prudential and consumer protection, the entities providing DLAs will be required to be subject to prudential regulation and the same capital standards as other longevity products.

It would be difficult to conclude other than that these arrangements will provide a more level playing field for DLAs alongside other SIS pension products.

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