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Family and Community Services and Veterans' Affairs Legislation Amendment (Income Streams) Bill 2004

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Contents

Family and Community Services and Veterans' Affairs Legislation Amendment (Income Streams) Bill 2004

Date Introduced: 26 May 2004

House: House of Representatives

Portfolio: Family and Community Services

Commencement: 20 September 2004

Purpose

To amend the asset test treatment of retirement income stream products in the *Social Security Act 1991* and the *Veterans' Entitlements Act 1986*, as part of a broader package of retirement income reform measures announced in the policy document *A More Flexible and Adaptable Retirement Income System* issued by the Treasurer on 25 February 2004.

Background

Income Stream Products

The treatment of income stream products by the social security and veterans' entitlements means test and for income taxation purposes has evolved over recent decades in response to the increased use of these products and their changing structure. In recent years two main types of income stream products have been available: complying pensions and allocated pensions.

Complying Pensions

These income streams are paid for the recipient's lifetime or for their life expectancy. A *pension* is provided by a superannuation fund and can only be purchased with superannuation monies. An *annuity* can be purchased with any monies. Lifetime or life expectancy income streams provide a guaranteed series of payments (paid at least annually).

To provide a fixed income stream over a long period these products usually rely on fairly secure and low risk investments which limits the investment earnings that are possible. They also lock up retirement savings so that they cannot be accessed if requirements change. These features have made them much less popular with retirees than the more flexible allocated products.

Allocated pensions

Since the early 1990s allocated pensions and annuities have become the most popular structured private retirement income stream plans in the financial market. Also, there are rapidly increasing numbers of self-managed superannuation funds that are being designed to switch from accumulating benefits to income streams. The advantage of these income streams is that:

- they can be designed to meet individual needs
- money can be pooled into a diverse range of managed investments, responsive to market fluctuations and trends so as to maximise earnings
- account balances can rise and fall with fluctuations in pooled fund earnings and market value of investments
- money is not necessarily locked away and there is scope to make capital withdrawals
- there is capacity to vary income received
- there are tax advantages for income withdrawals if taken at a steady pace, and
- investment income earned is not taxable.

The popularity of allocated pensions was boosted by the performance of the equity markets during the 1990s. Recent experience with the equity market has highlighted the dangers of relying on allocated pensions alone and encouraged discussion about new income stream products that combine the certainty of complying pensions with the market linked returns of allocated pensions.[1]

Market-linked non-commutable income stream products

The financial services industry and the Government have been looking at "growth pensions" for a few years now. Proposals for an income stream product that would give better returns than existing complying pensions but still qualify for favourable assets test treatment have been floated by the Investment and Financial Services Association (IFSA) a number of times in recent years.[2] The Senate Select Committee on Superannuation also backed growth pensions in their report issued last year.[3]

Income and Assets Testing

In the 1997-98 Budget, the Government announced changes to the pensions and benefits income and assets tests treatment of income stream products.[4] The reforms were mainly in response to the burgeoning use of income stream products by retired people and the increased diversity, design and complexity of these products. The main concern was that some people were able to organise substantial assets into mechanisms that circumvented the income and assets testing arrangements. The other issue was to provide some favourable treatment of income and assets testing towards those investments that were long-term and genuinely providing an income stream in retirement. The changes were introduced with the passage of the *Social Security and Veterans' Affairs Legislation Amendment (Budget and Other Measures) Act 1997*.[5]

Currently, most investments are subject to the income and assets tests. Under the current rules, income stream products are generally caught by both income and assets tests, with some exceptions. For the income test, special rules apply as the income stream payments generally include a return of a part of the capital used to purchase the product. Mostly, it is only the income part which is counted under the income test. In brief the features of the current treatment arrangements are:

Income stream type	**Income test**	**Assets test**
Long-term Complying life time/life expectancy with no residual capital*	Gross annual payment less a deduction based on purchase price	Exempt**
Medium-term >5yrs Some residual capital value	Gross annual payment less a deduction based on purchase price	Subject to assets test
Short-term <5yrs	Subject to income test under extended Deeming	Subject to assets test

* The prohibition on residual capital value was based on the view that it would be unreasonable to expect taxpayers to support the use of the product for purposes other than a retirement income stream, eg to intentionally leave a lump sum to the purchaser's estate.

** The asset test exemption for long-term products was aimed at providing an incentive for people to use lump sums to purchase an income stream that could be expected to last for the duration of their retirement, rather than relying on the age pension.

Basis of policy commitment

The policy document *A More Flexible and Adaptable Retirement Income System* issued by the Treasurer on 25 February 2004 sets out the rationale for the changes made by the present bill.[6] The aim of the package is to improve the accessibility, flexibility and integrity of the retirement income system and reduce red tape.[7] The package includes proposals to:

- remove the work test for superannuation for those under 65 years age and simplify it for those over 65 years of age
- require the payment of superannuation benefits to a person as soon as practicable after they reach 75 years of age regardless of whether they continue to work
- permit the provision of complying benefit market-linked income stream products from 20 September 2004
- make it easier for people to access their superannuation benefit once they reach their preservation age while still remaining in the workforce, and
- remove the requirement for superannuation funds, that only pay allocated pensions, to obtain an actuarial certificate so that the income generated by the assets supporting the allocated pension can attract a tax exemption.

Amendments to the legislation regulating superannuation funds which will recognise market-linked income stream products as complying pensions and annuities will be accomplished by amending the definitions of annuity and pension in the *Superannuation Industry (Supervision) Regulations 1994* (the SIS Regulations). Amendments are needed to the SIS Regulations to make changes to the work tests, transition from the workforce and compulsory payment of benefits after turning 75 years of age announced by the Treasurer.

The Superannuation Laws Amendment (2004 Measures No. 2) Act 2004, passed on 24 June 2004, includes provisions relating to two proposed changes included in the Treasurer's announcement of 25 February 2004. The amendments are to:

- the *Income Tax Assessment Act 1936* to remove the requirement for superannuation funds that only pay allocated pensions to obtain an actuarial certificate so that assets supporting the allocated pension can claim a tax exemption on the income they receive, and
- the *Superannuation Guarantee (Administration) Act 1992* to remove the notional earnings base provisions and require that an employee's ordinary time earnings be used as the base for determining the amount of employer superannuation contributions needed to satisfy the employers superannuation guarantee liability.

Other changes announced by the Treasurer were implemented through changes to regulations in late June 2004.

Asset test changes

The Government wishes to encourage the use of retirement income stream products through a range of incentives built into social security and taxation arrangements. At present the incentives on offer encourage the use of complying pensions. In order to encourage the provision and take up of market-linked income stream products, the Bill provides a 50 per cent assets test exemption to these products from 20 September 2004.

The Government has also come to the view that the present 100 per cent assets test exemption for complying income streams is overly generous because:

> It enables wealthy individuals with assets substantially above the assets test thresholds to obtain an age pension. This is inconsistent with the intended role of the age pension to provide retirement income for people who have not been able to fully save for their retirement. [8]

That exemption will be reduced to a 50 per cent exemption to match the treatment of the market-linked products from 20 September 2004.

Over the last few years there have been media reports suggesting that millionaires were able to arrange their assets so as to gain access to the age pension.[9] In some limited cases the present assets test treatment of complying pensions does allow quite wealthy people to receive the age pension. Those that take this option limit the earning capacity of their assets because of the relatively low returns provided by complying pensions.[10] They also lock up their assets in an inflexible product with no residual value. It is probably not a great drain on the public purse but the Government has chosen to remove the option for wealthier retirees.

Two further measures in the Bill will standardise the treatment of assets test concessions when an income stream product passes to a reversionary beneficiary and adjust the time period within which an asset test exempt lifetime income stream may be commuted. Both of these measures are beneficial.

Main Provisions

Item 1 of **Schedule 1** amends existing subsection 9(1) of the *Social Security Act 1991* to include market-linked income streams in the definition of assets test exempt income streams.

Item 24 of **Schedule 1** inserts **new section 9BA** into the *Social Security Act 1991*. **New section 9BA** provides the definition of market-linked income streams and is the main component of the Bill.

Item 29 of **Schedule 1** inserts the definition of a partially asset test exempt income stream into subsection 1118(1A) of the *Social Security Act 1991*. The main feature of this item is the 20 September 2004 dividing line between assets test exempt and partially assets test exempt income streams.

Endnotes

1 McIlraith, John. 'Dressing for Retirement', *Superfunds*, Dec. 2002-Jan 2003 pp. 38–40.

2 Hoyle, Simon. 'We need a better pension: report', *SMH*, 23 August 2003, p. 50. Bowerman, Robin. 'A new plan to boost wrinklies' earnings', *Age*, 17 June 2001.

3 Senate Select Committee on Superannuation, *Planning for Retirement*, 29 July 2003, p. 160.

4 Department of Social Security - Portfolio Budget Statements, Budget Related Paper No 1.14, pp. 59-60.

5 For background on this Bill see Susan Downing, Social Security and Veterans' Affairs Legislation Amendment (Budget and Other Measures) Bill 1997, *Bills Digest No. 136 1997-98* at: http://www.aph.gov.au/library/pubs/bd/1997-98/98bd138.htm

6 *A More Flexible and Adaptable Retirement Income System*, pp. 8–10. Available at: http://demographics.treasury.gov.au/content/discussion.asp?NavID=6#flexible_retirement

7 Peter Costello, *A More Flexible and Adaptable Retirement Income System*, Press Release, no. 11, Canberra, 25 February 2004. Available at: http://parlinfoweb.parl.net/parlinfo/Repository1/Media/pressrel/6MRB61.pdf.

8 ibid p. 10.

9 For example see Hughes, Duncan. 'Millionaires on pension row', *Age,* 20 December 2003, p.1 available at: http://parlinfoweb.parl.net/parlinfo/Repository1/Media/npaper_4/QS7B60.pdf

10 For a discussion of how this worked for wealthy retirees see: Freeman, Peter. 'Income Outcome', *Bulletin*, May 14 2002, p. 46-47. and 'On the Money', *Bulletin* 21 May 2002. pp. 48-49. Available at: http://search.aph.gov.au/search/ParlInfo.ASP?Folder=JRNART&Criteria=citation_id:ODU66;&action=bookmark and http://search.aph.gov.au/search/ParlInfo.ASP?Folder=JRNART&Criteria=citation_id:VDU66;&action=bookmark