Nature, Form, Characteristics and Genetics of Pension Superannuation – Should Size Matter?

by

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The appeal in *Semperton v Semperton* [2012] FamCAFC 132 has brought recent focus to a number of issues, including risk of double counting DFRDB (or any other pension) in payment phase, and also the need to understand how benefits accrue in order to be able to make better assessments of contributions thereto. The second case which should be appreciated in full is the judgment by Murphy J in *Hayton v Bendle* [2010] FamCA 592, a case involving a future judicial pension.

The cases highlight the need for awareness at all levels of some issues that have received little articulation. These issues are the five elephants in the room, which have been there for so long that their mahouts have either retired or died. These unmentionables will be addressed in this paper in an effort to stimulate discussion and hopefully a recognition that things, not just can be, but must be, done in a better way.

The Five Issues

It is respectfully suggested that the five issues (and there must be others) which beg for further elucidation include the following –

(a) A proper understanding of how the magnitude of a benefit grows in accordance with methods prescribed by statute or fund rules.

(b) An appreciation of the impact of taxation upon a party who will receive a superannuation benefit (which was a concern raised by Baumann FM in *Semperton*, and picked up by Thackeray and Ryan JJ upon appeal).

(c) An appreciation of the value of a social security pension received by a party including the value of medical and pharmaceutical benefits, concessions in respect of rates, telephone, public transport and other concessional entitlements not available to the self-funded retiree. This is particularly important where the quantum of social security pension received by one party is similar to the quantum of the DFRDB or other superannuation pension received by the other party.

(d) An appreciation that equity in an un-encumbered property has a different quality to that of the equity in a property that is subject to a mortgage which incurs interest. Alternatively, an appreciation that some of a party's future income will be spent on paying for the cost of re-housing post-judgment.

(e) Double counting – sec 79(4) and Sec 75(2)

Semperton was otherwise in many respects a model case, where there was no need for cross examination, no dispute about valuations of any "asset", and where the proceedings at first instance lasted less than an hour. With every relevant person determined to make the process as easy, time-efficient and as economic as possible, things went wrong, and the matter has been remitted for a retrial. The Full Court judgement constitutes a very helpful synopsis of cases leading to the present position,

but alerts readers to the need for further attention to what should be considered in the treatment of pensions in particular. Although it dealt with a pension in payment phase, much of what was said will apply to many cases involving future pensions.

The core of the problem ventilated upon appeal centered on two issues. One was that the Federal Magistrate included the calculated "value" of the DFRDB entitlement as a capital sum forming part of the available pool under Step 1, and subsequently took that same entitlement into account under section 75(2) in Step 3, which enlivened the "double count" argument upon appeal. The second was that his Honour failed to consider the "different character" of the DFRDB "at the final stages". For present discussion, other aspects are not relevant.

How the magnitude of benefit grows

Although there was a ground claiming failure to accord a contribution-based adjustment in favour of the husband for his post-separation contributions to "Fund A" and support of the wife in that period, there was no ground of appeal relating to the pre-cohabitation contribution to the DFRDB. In fairness to the Federal Magistrate, two things have to be said.

One is that the husband conceded that contributions were "equal", and the 2nd is that the Federal Magistrate did say in para 23 "… It could be argued that the husband's initial contributions to the DFRDB entitlement and his post-separation contributions to his Fund A superannuation could justify a slight contribution-based adjustment to the husband", his Honour was postulating what might have been an argument, without any assistance as to what would have been the real significance of the initial contributions of the DFRDB. His Honour was referring to the fact that the husband was in the Army for 5 years prior to cohabitation between 1967 and 1972.

It is also respectfully suggested that there is a need to do more than just to consider the nature, form and characteristics of a superannuation benefit, and that it is also necessary to consider the underlying principles on which the magnitude of that benefit grows. This is where the "genetics" of a benefit come in, and an appreciation of those principles will help judicial officers, and practitioners, to form a more accurate view of what were the relative contributions by each party to that benefit.

The *Semperton* decision is a useful means of opening up this discussion.

The husband had been in the armed forces for 25 years from 1967 to 1992, and upon retirement therefrom, he commenced to receive a DFRDB "retirement pay". He commuted the maximum portion permissible in 1992 in order to enable the parties to acquire a property. The lump sum entitlement in 1992 was 4.45 times his annual rate of retirement pay. Thereafter he had no right to make any further commutation election, and the balance of his benefit was payable to him at reduced fortnightly intervals as a pension. The amount of annual reduction of a DFRDB pension is ascertained by dividing his lump sum by the number of years of life expectancy according to the person's gender and age. The reduced pension then became his indexed retirement pension. For an appreciation of how this is done, go to the first link below[1]. Note that the reference to "Residual Pension Factor" is a euphemism for

[1] http://www.dfwa.org.au/download/references/MSBS/Brochures/adf-3.pdf

years of life expectancy. To see the current position in the DFRDB Book, go to the second link below[2], where you will also see that the lump sum multiple has been increase to 5.

The husband served in the armed forces for five years before the commencement of the relationship, i.e., from 1967 to 1972, that is for 20% of the total period of service.

Section 23 of the DFRDB Act provides, where relevant –

(1) Where a contributing member retires and is not entitled to invalidity benefit and:

(a) on his retirement:

(i) his total period of effective service is not less than 20 years; or

(ii) his total period of effective service is not less than 15 years and he has attained the retiring age for the rank held by him immediately before his retirement;

……..

he is entitled, on his retirement, to retirement pay at the rate applicable to him in accordance with this section.

(2) Subject to subsections (3) and (6) and to sections 25 and 75, the rate at which retirement pay is payable to a recipient member is an amount per annum that is equal to such percentage of the annual rate of pay applicable to him immediately before his retirement as, having regard to the number of complete years included in his total period of effective service, is ascertained under Schedule 1.

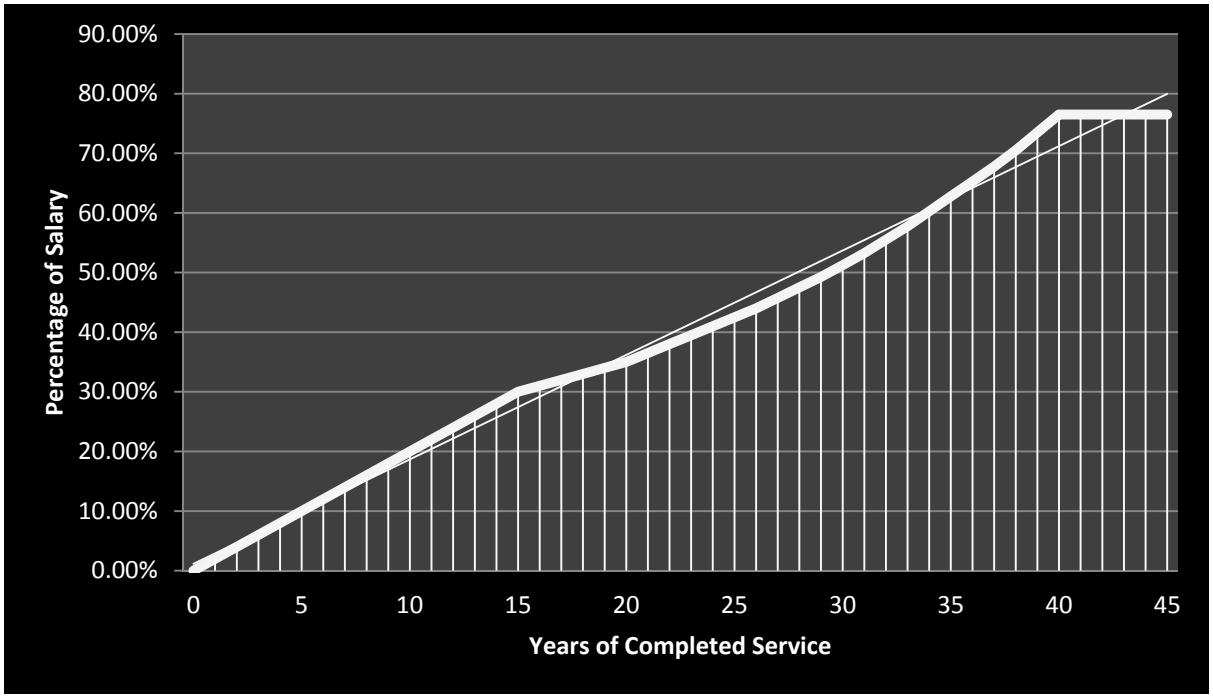
Schedule 1 provides the contents of the first two columns below. The third column is the writer's addition showing the rate of increase between one year and the next.

Years of service	Benefit	Growth pa
15	30.00%	infer the growth is 2%
16	31.00%	1%
17	32.00%	1%
18	33.00%	1%
19	34.00%	1%
20	35.00%	1%
21	36.50%	1.5%
22	38.00%	1.5%
23	39.50%	1.5%
24	41.00%	1.5%
25	42.50%	1.5%
26	44.00%	1.5%
27	45.75%	1.75%
28	47.50%	1.75%
29	49.25%	1.75%
30	51.25%	2.0%

[2] http://dfrdb.gov.au/storage/DFRDB%20Book.pdf

31	53.25%	2.0%
32	55.50%	2.25%
33	57.75%	2.25%
34	60.25%	2.5%
35	62.75%	2.5%
36	65.25%	2.5%
37	67.75%	2.5%
38	70.50%	2.75%
39	73.50%	3.0%
40 or more	76.50%	3.0%

A graph showing the growth of benefit as a function of completed years of service, together with a trend line showing how close that growth is to a straight line, is shown below. Where a service person served for less than 30 years, the highest rate of growth took place in the first 15 years of service.



En passant, for those who may be curious, the entitlement of servicemen who served for less than 20 years or less than 15 years respectively as set out in sec 23 above, consisted of a refund of their 5% contributions plus, in some cases, a modest graduated gratuity calculated by reference to the number of years of service. The lump sum representing the refund of contributions represented just the sum total of those contributions, without any deduction for administrative fees, nor any increase by way of interest in the intervening years. An alternative option was to preserve benefits in superannuation.

What is pivotal is the fact that having served for 15 years, and having attained retirement age for rank, the retirement pension benefit was 30% of salary. To borrow a phrase from Murphy J in *Hayton v Bendle*, in "plotting the increase in value" it would be reasonable to assume that the entitlement of a service person was accruing at 2% per year for those first 15 years. That is followed by a fall and a gradual acceleration of the rate of growth. The average growth over 40 years, after which

there is no further growth, is 1.91% pa. This exercise is consistent with what was accepted in *Hayton* that until the member qualifies, he is accruing a prospective pension. To quote "Mr B" in para 49, "… *the prospective pension entitlement was, then, 'accruing in the same way as a defined benefit superannuation interest would accrue'"*.

To put that reasoning beyond doubt, we see that Table 3 of the approval of the "Methods and Factors" for valuing DFRDB actually starts from year 1, and that shows a 2% "pension multiple" which then continues to accrue annually at that rate for the first 15 years.

In *Semperton*, the husband's pre-cohabitation period of service lasted for 5 years from 1967 to 1972. In that period it would be reasonable to "plot the growth" of entitlement which he eventually received, to about 10% by the time cohabitation commenced. He retired from the Army after 25 years of total service, in 1992. His entitlement multiple upon completing 25 years of service became 42.5%. It would therefore seem reasonable to infer that his pre-cohabitation entitlement had an impact on the eventual entitlement equal to about a quarter.

The husband's DFRDB benefit in payment phase had been valued at $354,098. It would have therefore been possible to have recognized his pre-cohabitation contribution to that component as being something equal to about $88,500 in 2010 dollar terms. Had the husband not made the concession of equality of contributions, there could have been a very significant argument mounted. One thing would have been made clear and that is the initial contribution could not have ever been thought of as justifying just a "slight adjustment" in favour of the husband.

The reference to "slight adjustment" probably stems from a frequent misunderstanding that service prior to cohabitation 20 or more years ago can only be reflected in a relatively small values of superannuation.

The problem is this: The comparison of the magnitude of the of the "family law value" in say, 1972, with the magnitude of the value calculated by means of the formulae in 2010, is meaningless and not even logically connected. It is but an attempt to compare apples with oranges.

The "family law value" according to the formulae, of a benefit back in, say, 1972, would be calculated by, among other things, reference to the product of the pension multiple and the member's salary back in those days. This would make the result unreal because of devaluation of the dollar and salaries now look numerically much larger.

However the low numerical salary in 1970 is irrelevant. The party who is before the Court in say 2010, is having his or her superannuation valued as at 2010. The benefit may have changed from growth phase to payment phase. In either event the current salary, or current pension level, are used to calculate the value.

To gain a valid idea of what portion, in 2010 dollar terms, of the 2010 value, can be said to be attributable to service prior to cohabitation, one can only turn to the movement in the pension multiple if that pension multiple is determined by reference to years of service.

Therefore to gain a better appreciation of the importance of what had been accrued in say, the 5 years prior to cohabitation in *Semperton*, calculate the ratio of the value of the accrued pension multiple in 1972 to the value of the pension multiple applicable to completion of 25 years of service in 1992.

In *Semperton* it can be taken to have grown from 10% (notional figure at 5 years) to 42.5% upon exit in 1992 on completion of 25 years, or a ratio of about 1:4.

Where the benefit has moved into payment phase, and the Court has been given the FLV in 2010 of that pension, the significance of a member's contribution in those first five years of service can be recognized as being about 25% of the FLV. The DFRDB was valued at $354,098 and 25% represents $88,524. Carrying that into the super pool of $520,250 the husband's contribution assessment could have started at 58.5% (which would correspond to a differential of $88,524).

In fairness to his Honour, a judicial officer is not expected to delve into the DFRDB Act in order to take judicial notice of what is in sec 23 and Schedule 1, or any other applicable statute, deed or rules.

That is not the end of the argument about the DFRDB. There are two further matters.

Firstly, the husband also commuted the maximum amount he could upon exit from the Army and then applied that lump sum towards family property. We do not know from the judgment what that sum was, but "maximum" in 1992 was defined to be 4.45 times the rate of retirement pay. The husband's pre-cohabitation contribution thereto should have also been recognized as having been about 25%.

Secondly, the husband was receiving his indexed retirement pay, and whatever that figure was, it had within it a component attributable to those first five years of service. This too should, if the argument was put, be taken into account as additional income. That component of his pension would have to be similar in nature to an income stream coming from an asset that a party owned prior to marriage. With these undocumented additional benefits, the husband's 58.5% demonstrable outcome in respect of the pension alone could have been carried into the assessment of contributions to the DFRDB without further discount.

The Impact of Taxation

Quite properly, Federal Magistrate Baumann raised the impact of taxation upon the real value of a DFRDB pension. This issue crops up in settlement discussions and in conferences with clients rather than in judgments. Perhaps it will now be addressed more often. His Honour did not have any expert or financial evidence. It was raised and discussed further by Thackeray and Ryan JJ at [159 – 166] upon appeal, and this may give it the necessary impetus for real attention to be given to taxation of benefits.

Yes it will cost parties to obtain accounting and actuarial expert evidence on what is likely to be the impact of taxation upon each individual. The process will be complex, because the impact of taxation depends on many considerations which are beyond the scope of this paper.

Value of Social Security benefits – or any other form of pension.

Putting political correctness aside, if a superannuation pension is to be considered at its calculated "amount" would it not be fair to have any pension that either party may receive capable of being "valued" and treated the same way? This question is raised in the hope of increasing awareness of potentially significant injustice.

Semperton throws a light on a potential lack of fairness in the treatment of individual parties.

It does not take much imagination to realize that pension streams from the government are highly valuable in the context of people eligible to receive them, when one takes into account the sundry benefits that flow by way of medical and pharmaceutical benefits, rent subsidy, rates concessions, telephone concessions, travel concessions etc, that the superannuated retiree might not be eligible to receive. In other words, the value of a superannuation pension might often be worth less to a recipient than the value of a similar level of Social Security pension might be to the other party.

Equity might not be what we think is "equity" where there is a mortgage.

Another feature of *Semperton* was that the wife was to be retain the family home unencumbered while the husband was to have the former investment unit which was subject to a mortgage of $155,250 and some liability for CGT. The practice of looking at the arithmetical "equity" for each party by simply arriving at the result by deducting debt from the value of a property is, with respect, likely to be inadequate in a great many cases.

In *Semperton* the husband's unit was worth $315,000 and after the mortgage, his "equity" looked like $159,750. The wife had an un-encumbered house worth $615,000.

The problem is that apart from paying off the capital to have an unencumbered place of abode, the husband also had to pay interest. Taking a simple example from the NAB website, if he borrowed $155,250 over 10 years, the repayments would be $1,785 per month and the interest alone would be $58,953. If he committed himself to a term of 5 years, the monthly repayments would be $3,058, the interest would amount to $28,232. At his age, he might not be able to work longer than that, but the shorter option would probably be unaffordable.

In those circumstances, is it fair to think of him as having an equity of $159,750? Surely there is a need to look further.

Please remember that most judgments ordering one party to pay, say, $xxxx to the other party, are not arrived at with any assistance of what that means in real terms.

Double Counting – or peeling back a contribution finding?

An examination of the argument that the Federal Magistrate fell into error by double counting the DFRDB calls for close analysis.

The core of the problem was that the amount calculated to represent the DFRDB pension was treated "as though it was an available capital sum" – May J at 97.

To have the DFRDB in *Semperton* so treated and then taken into account again under sec 75(2) was the basis of the complaint. This risk of "double counting" was precisely what Justice Coleman was careful to avoid in relation to the future Comsuper pension that the husband was expected to receive in *Cahill v Cahill*[3]. See para 92, 94 and 95.

The approach taken by Justice Coleman in *Cahill* in paragraphs 75 to 82 and in *McKinnon v McKinnon*[4] are logically supportable. His Honour's approach did not ignore the value of the DFRDB pension, as is shown in para 74 –

> 74 *It will be discerned that the Court …. is suggesting a distinction between taking into account, for the purpose of determining the assets of parties to proceedings, assets which have a theoretical value such as the husband's DFRDB entitlements, and having regard to the realities of life surrounding such entitlements and reflecting them in the evaluation of contributions. The terms of s90MC do not appear to raise an obstacle in the path of so doing. It is one thing to "treat" superannuation as "property" to enliven the jurisdiction of the Court to make an order in respect of superannuation, another altogether to suggest that superannuation must thereby be treated the same way as existing or tangible assets when entitlements of parties are determined pursuant to s 79 of the Act.* (underlining added)

Readers will be conscious of the expressed divergence of judicial opinion at appellate, or highly respected, levels as to how pension-style superannuation should be treated. Examination of actual outcomes will probably show that the divergence of opinion is found more in the expressions used rather than in the outcomes under sec 79.

Justice Coleman's approach was approved by Justice May at [89] and [92] in the *Semperton* appeal, and also by Justice Cronin in his joint judgement with Justice Coleman in *Edwards v Edwards*[5].

So when is it permissible to take a pension entitlement into account at Step 1 and also in Step3, and possibly Step 4?

Justices Thackray and Ryan said at [151] that they did not read Justice Murphy in *Hayton & Bendle* as "*supporting the proposition that every income stream can legitimately impact on the section 75(2) adjustment in circumstances where it has already been included in the asset pool*." That may well be right if one places emphasis on the flexibility of dealing differently with items having different natures, forms and characteristics. That legitimate flexibility should dissolve the question of which of the approaches, whether in *Hickey* or in *Coghlan* was right, or less correct.

Looking at para 74 from *Cahill* above, one can also see that the outcome in *Hayton* may actually be consistent with *Cahill*. In some cases the search for figures that

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[3] *Cahill v Cahill* (2006) FLC 93-253
[4] *McKinnon v McKinnon* (2005) FLC 93-242
[5] *Edwards v Edwards* (2009) FLC 93-409

reflect relative contributions can be assisted by looking at the statutes or rules that determine the genetics of a benefit. Sometimes the size determines the method of treatment.

It is respectfully suggested that the outcomes in both *Hickey* and *Coghlan* could have been arrived at by adopting either approach. The comforting feeling one gets from *Coghlan* is that it is easier to understand the path of reasoning, and the leaps from words to figures seem to be less hazardous. There is otherwise no need for deciding which approach was right in absolute terms.

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