THE TAX INSTITUTE

THE MARK OF EXPERTISE

22 July 2016

Ms Jenny Wilkinson
Division Head
Retirement Income Policy Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: Jenny.Wilkinson@TREASURY.GOV.AU

Dear Ms Wilkinson,

Budget 2016-17 superannuation announcements

The Tax Institute wishes to make a submission on the the superannuation tax announcements that were made in the 2016-17 Federal Budget.

Broadly the Government is to be commended for putting forward a primary objective of superannuation to be enshrined in a separate Act, for confirming retirement tax exemption for a greater suite of longevity risk products and for the number of contribution simplification measures announced.

However, there are matters which are still to be addressed in the announcements regarding:

- **(future tax changes):** how the announced primary objective of superannuation could be clarified so that it will not be used to make further adverse changes to the taxation of superannuation in the future and cause uncertainty;
- **(new caps technical aspects):** a number of technical aspects of the announced caps, in particular associated with the new $500,000 lifetime non-concessional contributions (NCC) cap; and
- **(implementation costs):** minimising the administration cost impact of the proposed changes to superannuation funds.

Objective of superannuation

The Tax Institute broadly agrees with the primary objective that superannuation should be to provide income in retirement, however:

(a) we reiterate the concern from our 6 April 2016 submission that linking the primary objective solely to the Age Pension is undesirable;

(b) a primary objective of superannuation should endorse support for all the three long-held pillars of income in retirement - the Age Pension, compulsory superannuation savings, and voluntary superannuation savings. In particular, we should be

Level 10, 175 Pitt Street
Sydney NSW 2000

Tel: 02 8223 0000
Fax: 02 8223 0077

info@taxinstitute.com.au
taxinstitute.com.au
ABN 45 008 392 37

encouraging the principle of self-provision in retirement to provide a comfortable lifestyle especially now there are strict contribution limits and also restrictions on the tax free level of assets that can be maintained in the super system from mid-2017.

(c) all announcements of superannuation tax change should provide ample time for systems changes to be made and be accompanied by a detailed explanation of how the change advances the objectives of superannuation, with included economic analysis.

Allow anyone up to age 75 to deduct personal concessional contributions

The Government is to be commended on this simplification measure. To further improve on this measure we suggest the following:

(a) **PAYG withholding:** To make contributing into superannuation even easier, the Tax Institute submits that complementary PAYG withholding exemptions should be made to allow employees to provide employers with payment directions for personal contributions (much like split banking of pay). For example, where an employee wants to contribute $25,000 pa. to super from their after-tax pay, the employee can direct their employer to contribute any amount over their usual Superannuation Guarantee threshold directly to their chosen super fund. This will allow employers to shift away from salary sacrifice agreements which are more expensive to manage than payment directions.

(b) **Notices of deduction** (NODs): NODs will become much more prevalent given that an employee, self-employed and eligible persons will be able to claim a tax deduction without needing to rely on the 10% rule in s 290- 170 of the ITAA 1997 from mid-2017. Presently there are strict rules regarding NODs. For example, an NOD must be provided before the earlier of the lodgement of the individual's tax return for the relevant year of income or the next 30 June. Further, an NOD must be provided prior to commencing a pension that includes any part of the contribution. The Tax Institute submits that greater latitude needs to be provided where the member falls short of meeting the approved form, validity and time requirements and the complexity of the existing NODs. The greater latitude should be in the form of giving the Commissioner the power to exercise a discretion.

Normal contribution rules for individuals aged 65 to 74

The Government is to be commended on this simplification measure, particularly with respect to:

(a) **Work test:** Past Tax Institute submissions have noted the complexities associated with applying the work test between age 65 and 74. Abolishing the test is welcome.

(b) **Spouse contributions:** Allowing spouse contribution offsets to age 74 (together with raising the income threshold to $37,000) is similarly welcome.

$25,000 concessional contributions cap

(a) **Maximum contributions base:** It should be confirmed that the indexed concessional contributions (CC) cap will never be exceeded by contributions at the Superannuation Guarantee rate (which will reach a permanent 12% from 2025) made on earnings equal to the maximum contribution base ($206,480 annualised on 1 July 2016 and indexed annually). Accordingly, indexation of the maximum contributions base should be linked to the indexation of the CC cap. In the event that an employer is obliged to contribute in excess of the CC cap, the employee should be given the option of electing to instead receive only the capped amount.

(b) **Two jobs:** SG contributions if the employee has two employers and full contributions from both employers at the SG rate would cause an excess. Individuals should be able to opt out of receiving excess .That would resolve the burden of annually completing release authorities for the excess and all the related administrative issues that arise with excess contributions.

(c) **Defined benefit grandfathering:** Defined benefit members do not have control over the level of their employer contributions, nor can they necessarily withdraw excess concessional contributions. As was allowed in 2007 and again in 2009 when caps were reduced, grandfathering of the CC cap should again be provided from mid-2017 for existing defined benefit members so that the cap is not exceeded each year. Without an extension of grandfathering, the interplay with the announced lifetime NCC cap could be particularly onerous for some defined benefit members if that cap is also reached, with 'double tax' at 95% then potentially applying to the excess contributions.

5-year rolling concessional contribution cap if less than $500,000 super savings

The Government is to be commended on this measure to improve superannuation outcomes for (i) individuals with broken work patterns, particularly women, and (ii) as a replacement for the higher transitional caps for those individuals who are approaching their retirement. The Tax Institute submits that the following details will need to be clarified:

(a) **Contributions to pay insurance premiums:** The Tax Institute submits that contributions to pay insurance premiums, on policies related to personal injury, disability or death, should not count towards the $25,000 CC cap (nor the lifetime NCC cap). These contributions are dissipated effectively immediately by on-payment to the insurer and are not available to provide retirement benefits.

(b) **Spouse contribution splitting:** the maximum splittable amount where the 5-year rolling cap can be applied should be confirmed.

(c) **How cap to be applied in practice:** The ATO should (i) collate member contribution statement (MCS) reporting data submitted by superannuation funds in October following year end and (ii) write to members before Christmas advising of their aggregated balance and available cap as of 1 July. If a member relies on that ATO advice to make additional contributions, but due to subsequent amended MCS reporting the contributions turn out to be excess, then the excess ought to be disregarded.

Div 293 tax threshold from $250,000 personal earnings

In the Budget costings, this change was bundled with the cut to the $25,000 CC cap. Separate (gross and net) costings need to be provided for the Div 293 change to allay concerns as to the administrative costs associated with this measure. Separate costing might also form a logical basis to present as an explanation for why $250,000 was chosen as the threshold as opposed to some other amount.

Replace Low Income Superannuation Contribution with a tax offset for the fund

Making permanent the tax break of up to $500 on concessional contributions for low income earners is welcome but the Tax Institute has concerns with the new form of the tax break:

(a) **If it's not broken, don't fix it:** Changing from a Low Income Superannuation Contribution (**LISC**) to a tax offset will unnecessarily create implementation costs for superannuation funds to change their administration systems.The ongoing related ATO expense associated with this measure of $101m per annum seems an extraordinary cost for a program that is projected to provide benefits of $600m to $700m per annum, when the annual related ATO expense associated with the existing LISC was budgeted as only $35m for 2013/14.

(b) **Loss years**: The non-refundable nature of the proposed tax offset means that low income members could miss out on the tax break entirely in years that the fund makes a tax loss due to poor financial market performance.

(c) **Rollovers:** An added complication of a tax offset is which fund should claim it (if any) if the member's interest has since been rolled over to another fund, either voluntarily or involuntarily such as through a successor fund transfer. It would be unfortunate if the offset were to become a blocker to rollovers and successor fund transfers occurring without disadvantage to members.

(d) **No longer a member of any fund:** A related issue is how the benefit of a fund tax offset is to be provided to an individual if he or she has withdrawn all of his or her superannuation and ceased to be a member of any fund. A tax offset to the fund does not need to be applied by the fund trustee for the benefit of the individual as a contribution needs to be.

(e) **Quantum of the $500 tax break:** In line with adopting a principled objective for superannuation, the principles of superannuation tax rules should also be clearly transparent. To that end, the Tax Institute submits that the $500 tax break should increase with the SG rate. A $500 tax break had a logical basis when the SG rate was 9% because $37,000 income x 9% = $500. However, $37,000 income multiplied by the current SG rate of 9.5% = $527. This tax offset should be adjusted to cover those on the relevant $37,000 tax threshold so there is no contributions tax payable on their compulsory SG or other super contributions.

$500,000 lifetime non-concessional contributions cap

The Tax Institute submits that the following issues should be considered in implementing this cap:

(a) **Disability insurance proceeds, personal injury settlements and death benefits:** Not all money in superannuation is used for retirement age living costs. For example, some money could be used for higher than normal health or living costs because of a particular individual's health or special care. This needs to be taken into account. The Tax Institute submits that consideration should be given to excluding each of the following from the counting towards the $500,000 cap:

  i. disability insurance proceeds and personal injury settlements contributed into superannuation; and

  ii. death benefits, whether paid to a spouse or a dependant child.

(b) **Application from 7.30pm on 3 May 2016:** Timing issues for contributions made before the Budget but only received by the fund after the Budget that could be resolved by making clear that excess contributions should be disregarded in those circumstances.

(c) **Defined benefit grandfathering:** As well as concessional contributions grandfathering already mentioned, non-concessional contributions grandfathering also becomes necessary for some defined benefit members to prevent the lifetime cap being exceeded by personal non-deductible contributions that are required under defined benefit schemes.

(d) **Indexation:** The legislation should clarify whether the cap will be indexed on a nominal or proportionate basis where it has been partially used up.

$1.6m cap on transfer to retirement phase

(a) **Transfer between retirement products:** Whether the $1.6m cap is exceeded should not be retested when moving between retirement products (including to or from superannuation annuity products), whether by rollover, successor fund transfer or reversion/commencement of a death benefit pension. If retested, the $1.6m cap may become a blocker to portability of superannuation between products or superannuation fund mergers.

(b) **Couples:** A combined cap should be able to be applied by couples because broken work patterns will often cause one person in the couple to have higher superannuation savings and the other to have lower (and often inadequate) superannuation savings. This would also help to resolve issues faced by defined benefit members who are unable to split contributions with their spouse, and provide a more equitable treatment between drawing a single life defined benefit pension and a reversionary defined benefit pension (i.e. a reversionary pension with an equivalent funding cost or commutation value, but with smaller annual payments because of the reversionary feature).

(c) **Disability insurance proceeds, personal injury settlements and death benefits:** As mentioned above, not all money in superannuation is used for retirement age living costs, and some could be used for other costs such as higher than normal health costs. Accordingly, the following pensions amounts should be excluded from the $1.6m cap:

   i. permanent incapacity pensions and pension amounts identified as being for higher than normal health and living costs; and

   ii. death benefit pensions, whether paid to a spouse or dependant child.

   Typically, many couples prefer to revert their pension to their surviving spouse. Thus, on the death of the first spouse, the surviving spouse should be entitled to obtain a reversionary pension even if it exceeds the surviving spouse’s balance cap. For example, if the husband dies first with a $1.6m retirement phase account and that reverts to the wife and the wife already has a $1.6m retirement phase account, then she would have a $3.2m effective balance cap. The special extension to the exempt current pension income measure under regulation 995-1.01(3) and (4) of the Income Tax Assessment Regulations 1997 (Cth) will need to be revised where the first spouse did not have an automatically reversionary pension.

(d) **How cap to be applied in practice:** The ATO should collate MCS reporting information and provide an annual statement of the available remaining cap to individuals in a timely manner.

(e) **Existing pension account balances over $1.6m:** Pension accounts that already have a balance exceeding $1.6m may have “lumpy” assets, for example, a $2 million property where only $400,000 needs to be rolled back to accumulation. Partial segregation of assets between retirement phase and accumulation phase should be allowed in these circumstances. The ATO have not accepted partial segregation beyond bank accounts. This results in unduly complex structures for funds to hold two parts of an asset through separate structures or separate vehicles, with resultant added transaction costs.

In addition, transitional rules should confirm that gains accrued on pension assets that need to be rolled back into accumulation phase because of the $1.6m cap are not taxed when the asset is ultimately sold. We note that the 2013/14 Federal Budget included a transitional measure to provide a tax exemption for gains on existing pension assets that accrued during the tax free pension phase or in the 10 years after that.

(f) **Existing annuities valued at over $1.6m:** The law should clarify the valuation method to be used to determine whether the cap is exceeded by existing annuities which may not have a commutation value.

(g) **Reserve allocations:** Allocation from reserves into pension accounts should not count towards the $1.6m cap. Only transfers from accumulation phase should able to result in an excess.

(h) **Time to calculate pension account balances:** The Tax Institute recommends a period of at least 12 months to establish the value of pension accounts as of 30 June 2017. The necessary accounting information and market values of assets is not likely to be available until many months after 30 June 2017. In many cases, the accounts will not be finalised until close to 30 June 2018 as obtaining an appropriate market value can take considerable time.

Longevity risk products treated as retirement phase products

The Government is to be commended on continuing to support implementation of this measure to allow greater retirement product development.

Other comments about longevity products have been incorporated into other items of this submission.

Transition to Retirement Pensions (TRP)

(a) **Implementation cost:** Significant fund systems changes may be required to tax earnings on TRPs. Pension systems do not apply tax, and accumulation systems are not set up for the regular payment of benefits. Therefore a third class of system may need to be developed for some funds specifically for TRPs. TRPs for members below age 60 are decreasing because of the rise in preservation age and will cease altogether on 1 July 2024. Given the systems costs necessary for what is essentially a temporary measure, the Tax Institute suggests the proposal to tax earnings on TRP balances at 15% should <u>not</u> proceed. Failing that, we suggest that consideration be given to denying the 15% tax offset for TRP drawdowns as a simple alternative to 15% tax on the fund earnings, as an elective alternative.

If the TRP change will still proceed as announced then the following additional matters are relevant:

(b) **Taxable component:** The matters below should be confirmed:

i. the taxable component of a TRP payment will still be equal to the taxable proportion set on commencement of the pension rather than adjusted each time a payment is made (as applies for lump sums paid from accumulation interests);

ii. the taxable component of the pension will remain the same once an unrestricted condition of release is met, for example reaching age 65 or retiring from work after having reached preservation age;

iii. the 15% tax will cease to apply to the TRP once an unrestricted condition of release is met;

iv. whether the $1.6m cap would apply to a TRP at commencement or at the subsequent time when an unrestricted condition of release is met - the latter may be more suitable given the $1.6m is meant to be a cap on assets committed to retirement phase that attract zero earnings tax.

(c) **Guaranteed products:** Some pension products (including defined benefits) provide long-term guaranteed annual incomes and/or guaranteed capital values on maturity or commutation. Adding a 15% tax on the earnings generated from the underlying assets supporting these products may mean the product terms will need to be adjusted to instead provide a lower guaranteed amount to the detriment of those individuals. If the TRP change will proceed as announced, then transitional measures should be put in place so individuals who already have guaranteed products are not adversely effected. Superannuation Industry Supervision (SIS) regulations may also need to be changed so that reduced guaranteed benefits continue to meet SIS minimum payment conditions.

Anti-detriment deductions

(a) **Date of death:** The Tax Institute submits that the date of death should be the relevant date for determining the cut off date for anti-detriment deductions, rather than the time the death benefit is paid which could be years later in some cases. A delay in payment could, for example, arise where the beneficiary cannot be located or where family members dispute payment of the death benefit by the fund.

Superannuation Guarantee simplification

The Tax Institute remains supportive of recommendations to simplify SG, in particular by aligning the SG charge with ordinary time earnings and calculating the 'interest' component through to the date of payment only. We also support making the charge tax deductible as for on-time contributions.

* * * *

If you would like to discuss any of the above, please contact either me or Tax Counsel, Thilini Wickramasuriya, on 02 8223 0044.

Yours sincerely,

Arthur Athanasiou
President