THE TAX INSTITUTE

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Submitted electronically: https://consult.treasury.gov.au/retirement-income-policy-division/super-reform-package-tranche-2/consultation/intro/view

Dear Ms Wilkinson

Superannuation reform package – tranche 2

The Tax Institute welcomes the opportunity to make a submission to the Treasury in relation to the *Superannuation reform package – tranche 2* set of exposure drafts and explanatory memoranda (**Tranche 2**).

Given the short timeframe provided for submissions on Tranche 2, the submission below does not purport to cover all of the substantive issues arising from this material. The Institute, along with its expert members in the area of superannuation, would be pleased to provide additional details on any of the matters set out below or to address the material in more detail in person.

Summary

The Institute submits that further consultation is required to discuss and resolve the technical challenges in administering the current measures in practice. We strongly urge the Government to consider the practical difficulties with some of these measures and be open to consider alternatives that could largely achieve the same objective, but also with the subsidiary objective that the superannuation system be simple, efficient and provide safeguards in mind.

Discussion

General comments

We submit that the consultation period for the superannuation reform package should be extended to allow a more considered redrafting of the exposure drafts. A consultation period of nine business days has been provided for the public to provide

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comments on Tranche 2, which comprises approximately 220 pages of exposure drafts and explanatory memoranda. This is an insufficient period to provide considered comments on this significant and complex material, which taxpayers and their advisers will be dealing with for decades to come.

Members of the Institute's Superannuation Committee also consider a start date of 1 July 2017 for many of the measures in the package is not realistic given the uncertainty around the final form of the legislation and the considerable systems and other work that trustees and administrators need to do to implement the measures.

We understand that some consultation on Tranche 2 has taken place on a confidential basis. The current drafting of the material focusses primarily on administration, procedure and systems. Given the volume of technical issues that have become apparent at the draft legislation stage (many of which are set out in this submission), we are concerned that an appropriate cross-section of stakeholders in the superannuation system have not been consulted at an early stage. We have heard from members whose organisations have been consulted on a confidential basis that they have not been able to gather feedback from other relevant stakeholders and experts within their particular fund or organisation to improve the quality of the legislative package.

While the explanatory memoranda for Tranche 2 predicts further consultation on some discrete issues, this form of ad hoc consultation coupled with the release of the superannuation reform package in tranches increases the risk of interaction issues, consequential amendments and any necessary transitional relief not being fully considered or identified. For example, the interaction between the introduction of the transfer balance cap in Tranche 2 with the amendments contemplated in relation to eligibility for making non-concessional contributions, cannot be considered because the non-concessional contribution amendments have not yet been released. Another example identified is how an excess above transfer caps will work where the super fund invests solely in investment policies with life companies which are taxed exclusively under Division 320.

We are concerned that the exposure drafts are inconsistent with the subsidiary objective of superannuation that the superannuation system be simple, efficient and provide safeguards. In particular, the drafting of Tranche 2 is overly complex and cannot be readily understood without reference to explanatory memoranda, which do not have legal force on a standalone basis. For example, the exposure drafts introduce approximately 23 new definitions into the tax law, with requirements to maintain account of multiple new superannuation concepts – including Transfer Balance Accounts, Personal Transfer Balance Caps, Unused Cap Space, Unused Cap Percentage and Highest Transfer Balance.

Further, we consider the use of accounting terms such as debits and credits in the transfer balance cap to be generally inappropriate in their application to the new superannuation concepts, and they may invite a quasi-accounting construction of the provisions – moving away from well-known legal principles and judicial concepts applied in superannuation and tax law. In addition, the draft material does not appear to adopt the strict accounting definitions and therefore could cause confusion for advisers and risk misinterpretation by superannuants. The uncertainty of announced measures and the substance that will ultimately become law means advisers cannot properly inform clients on these measures at this stage. Other than accountants, not many people are aware that a debit is an entry that affects the left side of an accounting ledger, whilst a credit affects the right side. In the absence of specialist assistance, which forces up compliance costs, the use of such concepts will result in mistakes being be made.

The media release issued by the Hon Scott Morrison MP, the Treasurer, on 27 September 2016 in relation to Tranche 2 states that 96 per cent of individuals with superannuation will either be better off or unaffected as a result of these changes.[1] The Institute wishes to point out that the likely substantial administrative costs of implementing these measures will not be limited to those individuals directly impacted by the measures in revenue terms.

Significant education, updating documentation, upskilling process and reporting costs will also be incurred by the industry and that will be incurred all members to implement the systems necessary to comply with these measures. For example, some industry funds have more than 5 million members but the key measures may impact very few within these funds but all of the members of the fund will generally be required to pay for the updated systems to cater for the new changes The complexity of the measures is also likely to lead to further costs and inefficiencies in terms of work created by misunderstandings and errors that requires a fair degree of learning and education to be rolled out to members by fund providers, advisers, ATO and Government. The costs of collection of each $1.00 of revenue from each proposal should be tested to ensure the costs are not out of proportion to the revenue gained. The industry-wide costs should be considered and not just a fund-specific cost.

Given the above issues, the Institute considers that the introduction of the measures to Parliament in sufficiently clear and certain form by the end of the calendar year is ambitious. The application of the majority of the amendments in Tranche 2 to commence on 1 July 2017 also provides insufficient lead time to finalise and implement the measures, particularly given that other tax measures such as the Attribution Managed Investment Trust regime and measures to improve compliance through enhanced third party reporting and data matching will also impact on large superannuation funds and also commence on 1 July 2017. Furthermore, Trustees and Registrable Superannuation Entities are already facing a myriad of regulatory reform measures from both APRA and ASIC (ranging from MySuper ADA transfers to enhanced disclosure/reporting with Regulatory Guide 97 Disclosing fees and costs in PDSs and periodic statements).

[1] http://sjm.ministers.treasury.gov.au/media-release/105-2016/

Transfer balance cap

Defined benefit funds

The Institute is concerned about the lack of clarity for how credits and debits are to be applied to the transfer balance account for members with multiple income streams across multiple funds where some of those income streams (lifetime pensions) are "non-commutable superannuation income streams" referred to as "capped defined benefit income streams". Special values are applied to determine the credit to the transfer balance account for members with lifetime pensions or certain other term pensions and then special rules apply to calculating the debit value of the income stream – unlike for other account based income streams where the actual lump sum commutation value is applied as a debit against the transfer balance account (possibly resulting in a negative balance).

As such, the Institute notes that the new rules will, in effect, require separate sub-accounts of the transfer balance account to be maintained in respect of lifetime pensions – because it would appear that a commutation amount (in respect of a lifetime pension or like income stream) cannot be applied as a debit to the transfer balance account without calculating the special debit value by reference to the special value credited to the account when the lifetime pension or like income stream commenced. Paragraph 1.186 of the Exposure Draft Explanatory Materials appears to confirm this:

> 1.186 The extent to which an excess is attributable to capped defined benefit income streams is worked out by reference to an individual's capped defined benefit balance. This balance is a sub-account of the individual's transfer balance account and includes all debits and credits that relate to capped defined benefit income streams. That is, the capped defined benefit balance reflects the net amount of capital an individual has transferred to the retirement phase in respect of capped defined benefit income streams. ***[Schedule 1, Part 1, item 3, subsection 294-125(3) of the ITAA 1997]***

There would appear to be a high likelihood for misunderstandings, misreporting and mistakes to occur in respect of these kinds of blended transfer balance accounts (operating with a sub-account). As a minimum, the Institute considers that the Commissioner should be given broad discretion to issue relief with respect to such matters.

Calculation of the cap (credits)

Credits to the transfer balance cap measure include death benefit/reversionary pensions. While the legislation makes it clear that any amounts over the transfer balance cap must be commuted it is not clear whether death benefits can be commuted into accumulation phase or whether they must be paid as lump sums pursuant to regulation 6.21 of the *Superannuation Industry (Supervision) Regulations* (**SISR**). The examples used in the Explanatory Materials for child pensions would suggest that the measures foresee that a cashing out of the excess as a lump sum will be required.

Spouses and other financial dependants have always been permitted to continue to hold their spouse's death benefits in their superannuation funds by way of a reversionary pension or death benefit pension. The examples used in the Explanatory Materials for child pensions would suggest that the measures foresee that a cashing out of the excess as a lump sum will be required. If funds are no longer permitted to provide pension benefits to reversionary spouses and children under age 25 and other financial dependants for amounts over the transfer balance cap (or adjusted cap in the case of child pensions) that is a significant change from the current rules. Such a position would also go against the rationale of the current measure (i.e. that the measure is not designed to stop members accumulating benefits but rather caps out the pension phase tax concession).

The Institute notes the likelihood of significant liquidity issues arising for some superannuation funds if substantial portions of current reversionary pensions are required to be cashed by 1 July 2017.

We submit that the legislation should be amended to permit death benefits being paid in the form of a pension under SISR (i.e. spouses, financial dependants and interdependents) to be commuted to accumulation phase and to not be required to be cashed out of the superannuation system. This could be in an accumulation account or a taxable pension account. Alternatively, such "excess death benefit pensions" could be retained as pensions but not qualify as exempt current pension income

As a minimum, this measure should be available to in effect grandfather any death benefit/reversionary income streams that have commenced prior to 1 July 2017.

It is also relevant to note in the context of death benefit income streams/reversionary pensions that many superannuation products may have been issued to members (and paid for) as a reversionary income stream product. A requirement to cause excess transfer cap amounts to be cashed out of the superannuation system significantly alters the structure of the product that members may have selected and paid for and the Institute submits this provides further support for allowing these death benefits to be retained in accumulation phase within the superannuation system

In addition to the comments above, we note the phrase "retirement phase recipient of a superannuation income stream" is used a number of times. It is submitted that the phrase "retirement phase recipient" is sufficient (and less circular).

Excess transfer balance determinations and tax

The Institute would submit that the Commissioner be given a broad discretion to remit excess transfer balance tax or disregard a certain period when determining the notional earnings where the delay in issuing a determination is beyond the control of the member. The Institute is particularly concerned that this may likely occur if insufficient lead time to finalise and implement results in delays with Funds reporting and/or ATO to issue determinations within a reasonable time of receiving all the information.

Miscellaneous

The Institute is also concerned about the penal nature of the imposition of a 30% tax on second and subsequent breaches of the cap due to the complexity of the measures and the length of time over which taxpayers are likely to be in receipt of income streams following retirement. There is a high possibility of one or more errors with respect to an individual's income streams across multiple providers and over periods in excess of 20 or so years. Further, it is noted that there is no equivalent concept for a further sanction to be applied to the capped defined benefit tax.

Catch up concessional contributions

Schedule 6 of the Treasury Laws Amendment (Fair and Sustainable Superannuation) Bill 2016 Exposure Draft contains amendments to the Income *Tax Assessment Act 1997* to give effect to the Government's 2016/17 Federal Budget measure 'Superannuation Reform Package – Catch-up Concessional Contributions'.

In our view, broadly the proposed changes are positive changes in terms of allowing individuals to make catch-up contributions where they have not fully utilised their concessional contribution caps in the previous five financial years, noting that the measure requires that they have a total superannuation balance of less than $500,000 on 30 June in year prior to making the catch-up contribution. This measure allows those who may not had the capacity or support in previous years to increase their superannuation account balances to a level commensurate with that which they would have enjoyed if the concessional cap had been fully utilised.

However, we note the following issues:

- The mechanism for allowing the catch-up is confusing.
- The basis for determining the total superannuation account balance at a particular time appears to contain an error.

Confusing mechanism for applying the catch-up

The draft legislation introduces two related but separate concepts - "unused concessional contributions cap" and "unapplied unused concessional contribution cap". For each financial year the "unused concessional contribution cap" is to be determined. It is the amount by which concessional contributions fall short of the concessional contributions cap for a particular year. This amount is not adjusted even where catch-up contributions are made in future years. Instead, a second concept of "unapplied unused concessional contribution cap" is introduced.

Rather than reducing the unused concessional contributions cap as it is utilised in making catch-up payments in subsequent years, the legislation requires a separate determination of the unapplied unused concessional contribution cap. As previously unused concessional contributions caps are utilised or applied, the unapplied unused concessional contribution cap reduces, but without reducing the unused concessional contribution cap.

The mechanism is likely to cause confusion given that the unused concessional contribution cap does not reduce as it is applied (or used). It seems a more logical and intuitive approach would be to determine the unused concessional contribution cap initially for a financial year, and then for the legislation to provide for this amount to be reduced as it is applied (or used) so that at any point in time the "unused concessional contribution cap" for a financial year reflected the amount that was otherwise available for the individual to use in making catch up concessional contributions

Total superannuation account balance

In Part 2 of Schedule 6 the draft legislation sets out a mechanism for determining the "total superannuation account balance" at a particular time. This is relevant in determining whether a member has a total superannuation balance less than $500,000 on the last day of the financial year preceding the year in which they wish to make catch-up payments.

The draft legislation breaks down the balance into separate components, and sets out a specific mechanism for determining the retirement phase value of an individual's total superannuation balance which arises because an individual has a transfer balance account. The explanatory memorandum in paragraph 6.28 described the approach in the following terms: "The retirement phase value of the individual's total superannuation balance is determined by the balance of their transfer balance account, adjusted to reflect the current value of account based superannuation interests in retirement phase." However, the specific mechanism in the proposed legislation appears confusing, unnecessary and potentially incorrect.

Specifically, section 307-230(2)(b) requires one to "increase the amount of (the transfer balance account) balance by the total amount of the superannuation benefits that would become payable if" the individual had a right to cause the superannuation interest to cease and voluntarily caused the interest to so cease. It seems that the word "by" ought to instead be replaced by the word "to" – that is, that the adjustment required is to the amount that the member would have been paid had they voluntarily ceased, rather than increasing it by the total amount they would have received in those circumstances (the latter appears likely to give rise to a double counting and over-inflation of the member's retirement phase value).

It is also unclear why such a mechanism is to be adopted and whether it achieves the outcome suggested in the explanatory memorandum. As an alternative approach it may be more appropriate that instead of taking the amount of the transfer balance account at the time and then seeking to increase it by an appropriate adjustment, that instead the balance of the account would be taken as the total amount of the superannuation benefit that would become payable if there was a right to cease the interests at the time and the individual voluntarily caused their interest to cease at that time.

Innovative income streams and integrity

New Deferred Superannuation Income Streams (DSIS)

These are income stream products which will enjoy the earnings tax exemption but will not have any immediate pension payment obligations until the end of a deferral period (say when the purchaser attains age 80). The requirements which a financial product has to satisfy in order to qualify as a DSIS are yet to be determined. Presumably there will be additional sub-regulations to 1.05 & 1.06 of the SISR. These products will be either deferred annuities issued by life insurance companies or “grouped self annuities” in which a cohort of pensioners in a large super fund forms a group so that any account balance released by early death of a member will be used to underwrite the payment guarantee. Presumably there will be restrictions on exiting the contract/cohort – as otherwise there will be no profits to transfer from those that die early to those that survive.

These products cannot be issued by SMSFs. Presumably the justification for excluding SMSFs from this type of income stream is that (a) there is no counterparty which will shoulder the longevity risk (in the case of deferred annuities – it is the issuing life insurance/registered organisation) or (b) that an SMSF does not have a sufficient number of members which can be grouped into a cohort where the longevity risk is shared amongst the cohort.

However, excluding SMSFs from DSIS may significantly reduce the attractiveness of SMSFs. A member concerned by longevity risk with $800,000 in super could buy an account-based pension with $400,000 and with $400,000 buy a DSIS where the deferral period ends at age 80. Under the new rules the $400,000 invested in the DSIS will from day 1 enjoy the “earning tax exemption” and only commence payment at when the deferral period ends – say when the investor is aged 80. (Strictly, if the DSIS is purchased before an unrestricted release condition has been satisfied, the earnings tax exemption only applies from the date an unrestricted release conditions occurs and the value of the DSIS will be credited to the transfer balance account when the earnings tax exemption applies to the product.)

The longevity risk of account-based pensions is magnified (if not created) by the minimum drawdown requirements in later years.

If the Government wishes to address the above discrepancy between the treatment of SMSFs and DSISs, the following changes could be made to the rules:

- reduce the excessive mandatory drawdown rate in later years or

- allow SMSFs to issue DSIS (albeit there will be no payment guarantee). To maintain integrity, the DSIS in an SMSF could operate by having the income stream commuted on death (if the account has not previously exhausted) and commutation payment made to the estate of the deceased member.

Transition to Retirement Income Streams (TRIS)

TRIS on the hand will not be recognised as a retirement phase income stream going forward and will lose their earnings tax exemption. It should be noted that for efficiency and economies of scale reasons, all assets backing pension liabilities are typically pooled into common investment asset pool(s). Members in large superannuation funds typically own units in these investment asset pools. The value of their account based income stream is determined by the number of units they hold in the particular asset pool x price. Earnings tax if it were to be calculated would be calculated at this investment asset pool level and not by pension type or down to member level.

To administer this measure, Funds would need to be able to attribute and isolate any earnings tax to just members in that asset pool that have a TRIS income stream. This will require asset segregation of the existing asset pool (shared by TRIS and non-TRIS members) with possibly CGT relief required in certain circumstances. Furthermore, the unit price would typically capture realised and unrealised income & gains and the earnings tax payable each year should be limited to just income and realised gains only and not unrealised.

The Institute is concerned with the cost and effort involved to deal with this particular class of pension and members. We submit that taxing the income stream benefits that these TRIS members received could achieve the same objective and not require any investment restructure and asset segregation. As an alternative, members who were preservation age to age 59 could lose entitlement to the 15% tax offset on their assessable income stream benefit, whereas those aged 60 and over but not retired could be taxed 15% on their income stream benefits.

Administrative issues

Commutation Authority

The Institute is concerned that the current 30 day time limit provided to superannuation income stream provider to comply is not reasonable. Particularly if as outlined in Paragraph 1.131 of the Explanatory Memoranda they are also required to make reasonable efforts to consult with the member first, to seek their wish/preference as to whether to roll the excess back to the accumulation phase or cash it out. We would submit that 90 days would be a more reasonable time frame to allow member and provider to discuss and process the request. Furthermore, there may be instances in which assets supporting the particular income stream may be temporarily illiquid or non-commutable and require more time for an orderly redemption in order to avoid unnecessary penalties and/or break costs.

In the event there is a failure by the superannuation income stream provider to comply, the consequence is that the investment earnings supporting that particular income stream will cease to be exempt from tax and deemed to be effective from the start of the financial year and for the whole income year. It should be noted that this particular calculation is extremely difficult in relation to members in a large superannuation fund whereby their interest in the fund is based on their share in a single investment asset pool (as noted above in relation TRIS). A failure to comply with a commutation authority has the effect of retrospectively deeming certain member(s) as not belonging to this particular tax exempt cohort. Significant build is required by large superannuation funds to overhaul their systems to calculate earnings tax based on the tax attribute of a member (i.e. member level, as opposed to investment asset pool level). At the very least, one would need to track what income and realised gains were attributed to each member in the investment asset pool, when currently there is no income distribution made to these members.

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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

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President