THE TAX INSTITUTE

15 December 2017

Division Head
Superannuation Tax Reform
Retirement Income Policy Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: superannuation@treasury.gov.au

Dear Sir/Madam,

Enacting announced reforms to Division 310 and the TOFA hedging rules

The Tax Institute welcomes the opportunity to make a submission to Treasury in relation to Division 310 of the *Income Tax Assessment Act 1997* (**ITAA 1997**) and the TOFA hedging rules.

In summary, The Tax Institute's position is that:

1. the Government should expedite drafting and enacting its announced extension to the (now) expired superannuation fund merger tax relief in Division 310 of the ITAA 1997;
2. the relief under Division 310 should be more effective in achieving its objective if certain changes are made; and
3. the Government should expedite drafting and enacting its announced major reforms to the taxation of financial arrangement (**TOFA**) rules.

Background - Division 310

The Government has been promoting superannuation fund consolidation to increase scale efficiencies. Several industry commentators have also recognised the merits of consolidation, with Rice Warner Actuaries[1] recently advocating for a 60% decrease in the number of APRA-regulated funds over the next decade. Division 310 relief was enacted to facilitate fund mergers.

[1] See Rice Warner Superannuation Market Projections Report, November 2017.

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When a superannuation fund closes and its members are transferred to another fund under a 'successor fund transfer' (**SFT**):

- the closing superannuation fund's carry forward tax losses and capital losses are permanently lost; and
- because all the closing fund's assets are disposed of, tax on unrealised gains are brought forward, rather than the amount of the tax remaining invested.

Both issues adversely affect the return able to be paid to the members post-merger. Therefore, this may mean the fund trustee is unable to be satisfied that a proposed merger is in the members' best interests, and consequently may not allow it to proceed. If the merger is able to proceed, the write off of any tax assets (tax losses and accrued offsets) can create a one-off detrimental adjustment to member accounts or unit prices in larger funds. This is a visible erosion of retirement savings at a time when it is estimated that around 5.1 million Australians are not likely to have saved enough for a comfortable standard of living in retirement[2].

Division 310 relief overcame both of these issues by allowing the closing fund to transfer its losses to the successor fund, and to roll-over its assets to the successor fund. Pooled superannuation trusts (**PST**s) and life insurance companies in which a closing superannuation fund invested faced the same issues when the superannuation fund merged, so Division 310 also allowed them the same relief.

However, the Division 310 relief expired on 1 July 2017.

1. Request for legislation to enact the extension to be progressed without further delay

The Government announced in the May 2017 Budget that the Division 310 fund merger relief would be extended to 1 July 2020. However, the extension has still not been enacted. Ongoing delay is creating uncertainty and preparations for contemplated mergers are delayed or unable to progress.

This places APRA-regulated superannuation funds in an untenable position of policy conflict between the prudential regulator (ie APRA), which has recently been strongly encouraging "sub-scale" funds to merge, and the ATO, which is not able to relieve funds from the potentially onerous tax costs of such mergers.

Ongoing delay is also inhibiting both ATO and APRA involvement in the merger process. This is likely to lead to compressed timeframes for these agencies in relation to considering merger-related applications once the extension is ultimately enacted.

[2] Source: Commonwealth Bank Retire Ready Index, February 2017.

The Tax Institute urges the Government to enact the extension to the Division 310 relief early in the next Parliamentary sitting period (ie February 2018). In the interim, The Tax Institute urges the Government to re-affirm its commitment to enacting the extension.

2. Making the relief more effective

The priority is getting the extension enacted as soon as reasonably possible. However, if there is flexibility to consider improvements to the form of the relief, The Tax Institute makes the following additional comments.

(a) Make the Division 310 fund merger relief permanent

This is not the first time the relief expired. The relief in Division 310 operated from 28 December 2008 and expired on 1 July 2011. Similarly, the relief operated from 1 October 2011 before expiring on 1 July 2017. Similar earlier relief under subdivision 126-F operated from 30 June 2004 to 1 July 2006.

It would better facilitate fund mergers on an ongoing basis and promote policy alignment if the tax relief to facilitate those mergers is made permanent. The Tax Institute submits that the Division 310 relief should be made permanent.

(b) Expand the scope of the Division 310 fund merger relief to substantially captive unit trusts

To implement the Government's MySuper initiative, Division 311 provided the same relief for compulsory transfer of member benefits as Division 310 provided for fund mergers.

Where the new MySuper product was in the same fund, recent and retrospectively enacted changes expanded the scope of Division 311 to allow assets to be rolled over between substantially captive unit trusts in the fund's investment structure (but losses could not be transferred).

The Tax Institute submits that the same expansion that allows substantially captive unit trusts to rollover assets should also be allowed under Division 310.

In addition, the substantially captive unit trusts should be allowed to transfer their losses under Division 310.

Larger superannuation funds can have hundreds of substantially captive unit trusts in the investment structure. The issue of unwanted realisation of gains and losses that become effectively lost when an SFT occurs arise equally for these trusts as they do for the closing superannuation fund itself (and the PSTs and life insurance companies in which the closing fund invested).

Expanding the scope of the relief to the underlying captive unit trusts facilitates further simplification of asset holding structures upon a fund merger, and ultimately could be expected to reduce administration costs post-SFT.

The Institute submits that, like the Division 311 changes, equivalent changes for Division 310 should be made retrospective.

(c) Recognise continuity of ownership of substantially captive unit trusts post-SFT

Substantially captive unit trusts will currently fail the 50% stake test under the ITAA 1936 necessary to continue carrying forward tax losses if units in the trust are transferred to a successor fund.

The Tax Institute submits that, absent the requested relief to allow these trusts to transfer their tax losses on an SFT, these losses should at least be allowed to be preserved in the trusts by legislating that the successor fund be recognised in place of the original fund when performing the 50% stake test.

The Institute submits that this change should be made retrospective.

(d) Use of PSTs and life insurance companies in the investment structure

As mentioned above, Division 310 allowed PSTs and life insurance companies in which the closing superannuation fund invested to participate in the relief on the same basis as the superannuation fund itself.

The Tax Institute submits that the proposed expansion of the scope of Division 310 relief for captive unit trusts should also be available where a closing superannuation fund has invested into a PST or life insurance company that in turn has invested in a captive unit trust.

(e) SMSF mergers

The Division 310 relief was never available where the continuing fund was an SMSF (or small APRA-regulated fund), or where the merger involved two such funds.

However, the relief is relevant for these funds and other recent legislative changes makes it more relevant. The Tax Institute submits the relief should be expanded to provide flexibility for these types of mergers.

For example, on the death of the last member of an SMSF (typically the surviving spouse), one or more of the deceased parents' children may already have an SMSF of their own. Those children may want to retain only one SMSF. Absent Division 310 relief, losses or accrued gains in one of those SMSFs could necessitate inefficient retention of both SMSFs. Adverse or prohibitive tax laws like this are classic examples of how red-tape creates inefficiency for taxpayers, and in this case, undermines the very objectives of the superannuation system.

The transitional CGT rules applicable from 1 July 2017 in particular could give rise to considerable capital losses for funds which apply the proportionate approach for their pension income exemption and have either a transition to retirement income stream or member account balance in excess of $1.6m. Further, some SMSFs with limited recourse borrowing arrangements have losses - both revenue losses from interest charges, and accrued capital losses if the property invested in has decreased in value.

For these reasons, The Tax Institute submits the relief should be expanded to provide flexibility for these types of mergers.

3. TOFA Reforms

In the 2016-17 Federal Budget, the Government announced that it would reform the TOFA rules to reduce the scope, decrease compliance costs and increase certainty through the redesign of the TOFA framework. The new rules were announced to take effect to income years on or after 1 January 2018.

The measure contains four key components:

- A 'closer link to accounting' which will strengthen and simplify the existing link between tax and accounting in the TOFA rules.
- Simplified accruals and realisation rules, which will significantly reduce the number of taxpayers in the TOFA rules, will reduce the arrangements where spreading of gains and losses is required under TOFA and simplify the required calculations.
- A new tax hedging regime which is easier to access, encompasses more types of risk management arrangements (including risk management of a portfolio of assets) and removes the direct link to financial accounting.
- Simplified rules for the taxation of gains and losses on foreign currency to preserve the current tax outcomes but streamline the legislation.

The Tax Institute urges the Government to enact the TOFA redesign framework early in the next Parliamentary sitting period (ie February 2018).

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If you would like to discuss, please contact either me or Tax Counsel, Angie Ananda, on 02 8223 0011.

Yours sincerely

Matthew Pawson
President