THE TAX INSTITUTE

THE MARK OF EXPERTISE

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Dear Ms Wilkinson

Transfers to Australia from foreign superannuation funds - urgent reform needed

The Tax Institute would like to take the opportunity to make a submission to Treasury in relation to the application of certain provisions in division 305 of the *Income Tax Assessment Act 1997* (**ITAA 1997**) and related legislative provisions.

Summary

The Tax Institute recommends the following changes in relation to sub-division 305-B of the ITAA 97 (**sub-div 305-B**):

1. Simplify the formula for calculating applicable fund earnings (**AFE**).
2. Remove the barriers to the transfer of benefits that have accrued in foreign superannuation funds that result from contribution caps and funding caps.
3. Reduce restrictions regarding elections to have an amount of AFE deposited with an Australian superannuation fund included in the assessable income of that fund notwithstanding that it is from a foreign superannuation fund.
4. Allow foreign income tax offsets (**FITO**) to be claimed by an Australian superannuation fund where the individual has elected for the fund to be assessable on the AFE but where the individual suffers personal foreign tax liabilities on that same amount.
5. The position for foreign currency conversions should be clarified to specifically deal with the calculation of AFE.

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6. Apportionment in the calculation of AFE should be allowed where part of the lump sum benefit is received at a later time as a pension entitlement.
7. If the law was clarified, we believe this should significantly reduce the need for Public Binding Rulings (**PBRs**) and reduce and time and cost involved for taxpayers to obtain information required to calculate AFE.

Background

The current division 305 of the ITAA 1997 (**div 305**) has its genesis in the former sub-division AA of the *Income Tax Assessment Act 1936* (**ITAA 1936**).

The former s 27CAA of the ITAA 1936 provided for the taxation treatment of a lump sum payment from an 'eligible non-resident non-complying superannuation fund' ("foreign fund"). The provisions applied from the 1995 income year.

A payment from the "foreign fund" to another "foreign fund" was not treated as a receipt or constructive receipt of the lump sum payment and did not give rise to a tax event in Australia.

The legislation provided that, unless the lump sum payment was made within 6 months of commencement of Australian tax residency, the assessable amount to the individual was the amount calculated in accordance with a formula in former s 27CAA. The purpose of the formula was to calculate the amount reflecting the investment earnings in the "foreign fund" from the time the individual became an Australian resident to the time the payment was made from the "foreign fund".

Prior to amendments made with effect from 1 July 2004, the calculated amount was included in the individual's assessable income and taxed at the individual's marginal tax rate (regardless of whether the lump sum payment was received by the individual or transferred directly into an Australian complying superannuation fund).

From 1 July 2004, the legislation was amended so that an individual could elect, subject to certain conditions being met, to have the assessable component of the payment treated as a taxable contribution where the lump sum was paid into an Australian complying superannuation fund.

Section 27CAA was repealed with effect from 1 July 2007. The provisions of sub-div 305-B were inserted into the ITAA 1997 with effect from 1 July 2007.

According to the Explanatory Memorandum to the *Tax Laws Amendment (Simplified Superannuation) Bill 2006*, sub-div 305-B is intended to replicate the effect of s 27CAA of the ITAA 1936. Paragraph 2.86 of the Explanatory Memorandum stated:

> "The existing tax treatment of superannuation benefits paid from non-complying superannuation plans will be maintained, however the terminology applying to these benefits will be simplified. In summary:
> ...
> - Superannuation lump sum benefits paid from 'foreign superannuation funds' continue to be taxed on the earnings while the person was an Australian resident."

From this it would appear that the intention of the legislation is to calculate and capture as assessable income the earnings accruing in the foreign superannuation fund at times during which the taxpayer is an Australian tax resident (subject to exemptions for certain amounts received within a 6-month period after becoming an Australian resident).

However, The Tax Institute considers that, in certain circumstances, the application of the provisions of sub-div 305-B (particularly the calculation of AFE) may result in unfair and/or unintended consequences for taxpayers and the ATO. Furthermore, there are a number of areas where the legislation (or its application) lacks certainty and clarification by legislative amendment, regulation or taxation rulings should be provided.

Analysis

1. Formula for calculating AFE

As stated above, the intention of the legislation is to calculate and capture, as assessable income, the earnings accruing in the foreign superannuation fund at times during which the taxpayer is an Australian tax resident.

In many scenarios, in applying the formula in s 305-75, the taxpayer is subject to tax on amounts that would be in excess of the amount that would generally be regarded as earnings accrued in the foreign superannuation fund whilst an Australian tax resident. Conversely, there are scenarios where the taxpayer may be assessable on amounts that would generally be regarded as less than the earnings whilst an Australian tax resident.

Below is a non-exhaustive list of situations where, The Tax Institute believes, the legislation does not operate as intended.

The amount in the fund that was vested

In many cases, benefits do not fully vest until a certain period of membership or employment with the employer group (often globally) has elapsed which may be after the first relevant period of Australian tax residency has commenced, and indeed, can include further periods of foreign assignment.

These benefit accretions from vesting are not from contributions and the additional vesting, especially when from further foreign service, is, in effect, treated as earnings and are included in AFE calculation. The Tax Institute considers that they more appropriately relate to the provision of further foreign service.

Subtracting and multiplying by proportion of days

The requirement in s 305-75 to subtract the total amount (including amounts attributable to contributions to the fund during the remainder of the period) and multiply by proportion of total days, has unintended consequences.

Paragraph (3)(a)(ii) of s 305-75 does not require a determination of when the contributions were made.

Contributions could be made during periods of Australian residency, but similarly the contributions could be made during periods of non-residency.

Subtracting all contributions from the formula, and then applying an apportionment for the total period of residency days can lead to distorted formulaic results.

Previous lump sums

Sub-section 305-75(4) adjusts the 'start day' where the lump sum is not the first lump sum from the fund that the taxpayer has received to which s 305-75 applies.

Section 305-75 only applies if there is an amount that would have been included in assessable income under ss 305-70(2) by the application of s 305-75, but for the payment having been received by another foreign superannuation fund. This does not allow for an adjustment to the start day if the earlier lump sum event was before 1 July 2007 (when sub-div 305-B became effective) or for when lump sums or other amounts may have been taken by the individual taxpayer whilst not an Australian resident (i.e. when sub-div 305-B would not have applied due to the individual's non-residency).

Previously exempt fund earnings

Sub-section 305-75(5) states that the taxpayer has an amount of previously exempt fund earnings if the amount would have been included in the taxpayer's assessable income under ss 305-70(2) by the application of s 305-75, but for the payment having been received by another foreign superannuation fund.

This does not capture a situation where:

- there was an earlier lump sum prior to 1 July 2007; or
- there was a transfer between foreign superannuation funds in a period of foreign residency between two periods of Australian tax residency (as no amount would have been included in the individual's assessable income by the application of s 305-75 at a time of non-residency).

In addition, for ss 305-75(5) purposes, in determining whether there is a “previously exempt fund earnings” amount, the amount in the fund must be attributable to an amount that is transferred from a foreign superannuation fund. On construction, “the fund” appears to relate to the fund from which the current lump sum benefit is being paid is being assessed. However, where there has been a transfer of some benefit from a foreign superannuation fund to another foreign superannuation fund, the amount remaining in the first-mentioned foreign superannuation fund would not be attributable to any amount that was transferred to the second-mentioned foreign superannuation fund.

The Tax Institute considers that clarification is required of this issue.

2. Discouragement of foreign superannuation fund transfers to Australia due to the application of non-concessional contribution caps

The contribution limits imposed through the taxation regime for excess contributions in div 291 of the ITAA 1997 discourage the transfer of benefits that have accrued in a foreign superannuation fund to an Australian superannuation fund.

Transfers from foreign superannuation funds should be encouraged (subject to appropriate integrity rules to ensure that contribution limits over a lifetime are not undermined).

Further, the proposed changes to the non-concessional contribution caps from $180,000 per annum to $100,000 per annum (or $540,000 and $300,000 respectively where the 3 year bring forward provisions can be invoked, a 45% reduction in the bring forward amount) severely hamper the ability for people who have accumulated superannuation benefits overseas to fund their retirement from an Australian superannuation fund, especially where they return to Australia near or after retirement.

The Tax Institute recommends removing these barriers to the transfer of benefits subject to appropriate integrity rules.

3. Restrictive election provisions

Extinguishment of benefits

The election provisions in s 305-80 of the ITAA 97 that enable AFE to form part of the fund’s assessable income currently require extinguishment of entitlements in the foreign superannuation fund. This means that the election provisions often cannot be satisfied.

This failure to satisfy is often due to the contribution limits. The requirement to withdraw excess contributions, if transferred to an Australian superannuation fund, can lead to significant adverse foreign taxation consequences to individual taxpayers. This is often so, particularly from a UK perspective, where such withdrawals could be treated as unauthorised payments for UK tax purposes.

The requirement that the taxpayer no longer has a superannuation interest in the foreign superannuation fund is also unclear in its application to different overseas fund structures, such as sub-plans within one provider. Conservatively, the election can only be used where benefits are held under a separate trust even if it is a different superannuation scheme.

Where there is a failure to satisfy the conditions for the election, the individual taxpayer is still personally liable for the taxation on any AFE even though the amount of the AFE is included in the amount that has been transferred to the Australian superannuation fund and may need to be 'retained' in the Australian superannuation fund environment until the member retires or satisfies another condition of release. In our view, this is onerous on the individual taxpayer.

There appears to be no rationale for the requirement to extinguish benefits in the foreign superannuation fund to be a condition for the election in s 305-80. Further, the current requirement of exhausting the overseas fund results in unnecessary costs. Therefore, The Tax Institute recommends that the requirement for foreign superannuation fund entitlements to be extinguished, should be removed as a condition for satisfying the election provisions in s 305-80.

Transfers

The provisions of ss 295-200(2) of the ITAA1997, in relation to including the amount elected under s 305-80 to be included in assessable income, refer to "amount transferred to the fund from a fund that was a foreign superannuation fund".

Very few foreign jurisdictions facilitate the direct transfer of benefits from the foreign fund to an Australian superannuation fund. In a similar way, Australian superannuation funds do not allow transfer payments of benefits to an overseas fund (unless the transfer is to a certain type of New Zealand superannuation fund - under the trans-Tasman portability arrangements.)

The Tax Institute recommends that the election conditions in s 305-80 be amended so that the conditions are satisfied where an individual receives a benefit from a foreign superannuation fund and deposits the funds with an Australian superannuation fund (within a limited time period).

4. Application of the FITO provisions

It is often the case, where the amount is transferred directly from a foreign superannuation fund to an Australian superannuation fund, that there is a foreign tax liability imposed on the individual and this liability may be by way of withholding tax or based on assessment when a foreign tax return is lodged.

It is noted, too, that in calculating the AFE amount the amount of lump sum benefit treated as being received is the amount before any deduction for foreign income tax. This has the effect of increasing the assessable amount either to the individual or to the Australian superannuation fund if an election under s 305-80 is made.

There can be unintended consequences where the individual has been able to elect that the Australian superannuation fund is to be subject to tax on the AFE component of the transferred amount under s 305-80 but has a personal foreign taxation liability.

In order for a FITO to be claimed:

- by the individual, the individual must be assessable on an amount included in their income; or
- if an election has been made for the Australian fund to be taxed, there is no income against which the individual can claim any FITO;
- by the Australian fund, the fund must have actually paid or be deemed to have paid, an amount of foreign income tax.

The Tax Institute recommends that an amendment be made so that where an election is able to be made to have the Australian superannuation fund subject to the tax on the AFE, the superannuation fund is able to claim the relevant FITO even though the fund itself has not suffered the foreign income tax but where the individual has suffered the foreign tax.

5. Foreign Currency translation

Sub-section 960-50(1) of the ITAA 1997 requires that an amount in a foreign currency is to be translated into Australian currency. The Table in ss 960-50(6) sets out the translation rules.

The ATO view (provided in ATO ID 2015/7) is that:

- Item 7 (translation of statutory income other than capital gain) does not apply as the lump sum received is not statutory income itself.
- Item 11 requires the amount of the relevant lump sum payment to be translated at the exchange rate applicable at the time of its receipt.
- Item 11A applies to the other amounts used in the method statements set out in sub-s 305-75(2) and (3) to calculate the individuals' AFE.

The ATO analysis in ATO ID 2015/7 reached the conclusion that an amount to which item 11A of the Table in s 960-50(6) applies is to be translated into Australian currency at an exchange rate <u>that is reasonable</u> having regard to the circumstances. In ATO ID 2015/17, the ATO considered that, <u>in the circumstances of that case</u>, the exchange rate at which it was reasonable to translate amounts used in the method statements set out in s 305-75(2) and (3) of the ITAA 1997 into Australian currency is the exchange rate applicable at the time of receipt of the relevant superannuation lump sum payment.

The Tax Institute recommends that further clarification is required for the rules in sub-div 960-C of the ITAA 97 in relation to the conversion of foreign currency amounts in respect of lump sums received from a foreign superannuation fund.

There are several methods for conversion that could apply. For example:

i. convert each component of the AFE formula to Australian dollars as at the date of the event applicable (e.g. vested amount at date of residency, date of further contributions, date of earlier transfer to another foreign superannuation fund, date of receipt of benefit or transfer to an Australian superannuation fund); or

ii. calculate all components in the foreign currency and convert the resultant amount to Australian dollars. However, this does not cater for the situation where currencies change in the foreign fund investments over the course of time.

The Tax Institute notes that, notwithstanding the above comments, when converting a previously exempt amount, where there is a transfer from one superannuation fund to another, TR 2003/12 states that the conversion of foreign currency to Australian currency should use the exchange rate applicable at the end of the year for this component. The Tax Institute considers that although the ruling has been withdrawn due to legislative change, the currency conversion legislation has not changed. Therefore, the approach in TR 2003/12 should continue in these circumstances.

There have been at least two views on the correct method of foreign currency conversion which have been published by the ATO and which can (and generally do) result in very different calculations of AFE.

The Explanatory Memorandum to the Bill which introduced sub-div 960-C of the ITAA 97 specifically indicated that any amounts which are elements in the calculation of another amount are to be translated prior to calculating the other amount.

In Taxation Determination TD 2006/54 it was noted that ss 960-50(4) requires that any foreign currency elements in a calculation must first be translated from foreign currency to Australian dollars before the final amount is worked out (refer also to TD 2006/30.) The ATO has also published PBRs which support this alternate view (refer PBRs 1011666190851 and 1011578805452).

The view of the ATO published most recently in ATO ID 2015/7, is that the calculation is to be performed by using the exchange rate at which it was reasonable to translate amounts used in the method statements set out in ss 305-75(2) and (3) of the ITAA 97 into Australian currency and that, in that case (which was a reasonably typical case where there were no previous exempt amounts or contributions since Australian residency commenced), it was the exchange rate applicable at the time of receipt of the relevant superannuation lump sum payment.

The amount of lump sum benefits paid from foreign superannuation funds can be substantial and movements in foreign exchange rates can be significant and volatile (particularly against certain currencies and on the happenings of certain events – eg the Global Financial Crisis and the Brexit vote). The different foreign exchange conversion views both within and outside the ATO means that the calculation of an individual's AFE can lead to significantly different taxation results.

The position for foreign currency conversion should be clarified, either by adding another Item to the Table on s 960-50(6), or within s 305-75 itself, to specifically deal with the timing of calculations of AFE and the conversion requirements from foreign currency amounts and elements in the calculation of AFE.

6. Apportionment - Lump sums and annuity entitlements

Sub-div 305-B deals with circumstances where a lump sum benefit is received from a foreign superannuation fund.

The ATO position has been made clear where there is:

- a partial lump sum benefit taken at the same time as a pension entitlement commences from the foreign superannuation fund; or
- a partial lump sum is taken but there has been no determination as to how the remainder of the benefit in the foreign superannuation fund will be drawn down in the future.

As stated above the legislation deals with lump sum entitlements, and the legislation does not appear to contemplate the circumstance where benefits from the same foreign superannuation fund may also be taken in the form of pensions over a future period, starting immediately or as a deferred arrangement.

The application of the ATO views can lead to unfair results. For example, the position where an individual takes a partial lump sum without yet determining whether a pension commences immediately. They are assessed on the amount of AFE as if the entire benefit was taken as a lump sum (limited of course to the amount they actually took as a lump sum). If a pension started shortly afterwards, that person would also be assessed on their pension income as ordinary assessable income. Compare this to the position where the pension also commenced at the time of the lump sum and only a portion of lump sum would have had the AFE calculation applied, whereby less taxation liability arises on the lump sum benefit.

The Tax Institute considers that these results are unfair and not intended by the legislation, Accordingly, the position regarding partial lump sum benefits should be clarified in the legislation. Specifically, apportionment in the calculation of AFE should be permitted where part of the benefit is received at a later time as a pension entitlement.

7. Complexity and difficulty in obtaining information

It can often be difficult to obtain information in relation to the ‘amount vested’ and it may not be possible to accurately determine the various amounts that become components of the calculation of AFE. It is especially difficult for vesting in defined benefit schemes as vested amounts in defined benefit schemes may not be well-defined where benefits are only payable upon reaching certain ages or change of work status.

This was recognised in paragraphs 45 and 51 of Taxation Ruling TR2003/12 (in relation to the previous provisions).

In many cases the relevant information may not be available and taxpayers may need to seek a PBR for clarity. Even where a PBR is sought from the ATO, the list of information required is extensive and often not freely or easily available.

The time and costs that can be involved in gathering the relevant information, and in some cases obtaining the services of an actuary, are often substantial.

There are many PBRs in this area. This is driven by the uncertainty that surrounds this area of the law. The Tax Institute considers that if the law was clarified, this should significantly reduce the need for PBRs and reduce and time and cost involved for taxpayers to calculate AFE.

Consideration should be given to an alternative notional calculation basis that could be elected to be used in circumstances where some of the elements or components of the existing formula for calculation are not available.

Conclusions

The Tax Institute considers this area of the legislation needs revising to provide better clarity and certainty and to ensure that the legislation is operating correctly for the benefit of the Australian community.

If you would like to discuss any of the above, please contact either me or Senior Tax Counsel, Prof. Bob Deutsch, on 02 8223 0011.

Yours sincerely

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