THE TAX INSTITUTE

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Michelle Dowdell
Retirement Benefits Unit
Retirement Income Policy Division
Department of the Treasury
Langton Crescent, Parkes
A.C.T. 2600

Email: Michelle.Dowdell@TREASURY.GOV.AU

Dear Michelle

TTI Superannuation Reforms Priority List – Proposed solutions – Residency of SMSFs

We refer to the Superannuation Reforms Priority list we submitted to Treasury and the Australian Taxation Office on 21 June 2018 (refer Annexure A). We also refer to our meeting with Treasury and the Australian Taxation Office on 1 August 2018. During that meeting Treasury indicated that it would be interested in hearing suggested solutions in relation to the reform issues we raised in our Superannuation Reforms Priority list.

The purpose of this letter is to outline our suggested solution in relation to the 'residency status for self-managed superannuation funds' (**SMSF**) issue raised in our Superannuation Reform Priorities List.

We submit that the legislation in relation to residency of SMSFs should be revised. The particular concern is that an SMSF can easily fail the 'Australian superannuation fund' test in s 295-95(2) *Income Tax Assessment Act 1997* (Cth) with substantial tax impost and there is currently no Australian Taxation Office discretion to allow the Commissioner to ignore such failures.

Therefore, the test needs to be made more appropriate for SMSFs as the current tests are difficult and have no flexibility if breached. Further, if an SMSF is rendered non-complying as a result of failing the 'Australian superannuation fund' test, there is a further tax penalty on such a fund gaining its 'Australian superannuation fund' test residency back. Accordingly, there is no incentive for such a fund to resume to be an 'Australian superannuation fund'.

We have listed our suggested solutions for Treasury's consideration below:

- Remove the residency test for SMSFs (and all funds).

- Alternatively, remove the test from the definition of a complying superannuation fund, but make it an operating standard with the Regulator having carriage of determining the appropriate consequence for the breach. It would be incumbent on the policy makers to determine what the mischief is that the residency test was attempting to address.

- Alternatively, revise the tests to remove the 'central management and control' (**CMAC**) test and replace it with a simpler requirement such that 50% or more of the trustees/board of directors of the trustee company must be Australian tax residents. Additionally, remove the contribution/active member test.

There appears to be no logical policy rationale for the automatic cessation of compliance status if a fund becomes a non-resident.

The test is two-fold at present: the contributions/active member test and the CMAC test. Given that the active member test really only impacts SMSFs (as a non-resident could still contribute to a large APRA Fund), the policy can't be based on preventing non-residents contributing to the Australian super regime.

The CMAC test can be difficult to apply, especially where technology allows meetings to occur by numerous forms of media.

We would be pleased to work with Treasury and/or the ATO to formulate a workable and practical solution to simplifying this issue.

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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

President

Annexure A

Priority	ATO or Treasury	Topic	Details	Suggested solution(s)
		TRIS		
1	ATO & Treasury	TRIS fixes	The law governing transition to retirement income streams (**TRISs**) should be clarified and, if needed, fixed.	
			There is a proposal to allow TRISs to revert on death even though the reversionary beneficiary has not satisfied a relevant condition of release (draft legislation awaiting finalisation). This change is welcome but is not be needed based on the following view of the law.	
			While the law appears clear (ie that a TRIS automatically converts to an account-based pension (**ABP**) on the member satisfying a condition of release with a nil cashing restriction if the governing rules allow such flexibility), the ATO argues that once an income stream is established as a TRIS it remains a TRIS. This view differs to that of certain sectors of the super industry (primarily those representing SMSFs) who have for a long time understood that the law converted a TRIS automatically to an ABP on the member satisfying a relevant condition of release. The industry view that a TRIS automatically converts to an ABP is detailed in the submission previously lodged by The Tax Institute. However, the ATO still argues that due to wording in the explanatory memorandum which accompanied the 2017 TRIS changes (to recognise a TRIS in retirement phase) that it does not. The ATO argues that once a TRIS, it is always a TRIS. This gives rise to unnecessary red tape and costs. Certain industry sectors have based their view on the law since mid-2007 and have been working with the practice of auto-conversion for many years (in fact the mid-2007 reforms encouraged auto-conversion from an allocated pension to an ABP and a TRAP to an ABP). It is acknowledged that some industry funds and APRA funds treat a TRIS as a separate product to a ABP and their systems are specified this way and do not facilitate auto-conversion. However, some of these funds may prefer to adopt an auto-conversion view and make system modifications to adopt the conversion of TRIS to ABP approach.	
			Options should therefore be pursued for simplifying the TRIS provisions. One option would be to recognise the automatic conversion from a TRIS to an ABP and that simplifies the differentiation between the TRIS and the ABP. Under this option, there would be no need to compare a TRIS in retirement phase to one that is not. This would remove the distinction between a TRIS in retirement phase. Certain modifications to the *Corporations Act 2001* (Cth) may also be needed. Another option is to allow the ability to take lump sums after a member attains their preservation age - but before reaching a full condition of release. Such lump sums could be limited to 10% of the member's account balance each financial year (**FY**).	Recognise the automatic co condition of release. There v This would simplify things ar
2	ATO & Treasury	TSB & TRIS interaction	Further, with the background above in mind (ie that once a TRIS, always a TRIS), this argument is now being relied on by certain advisers that argue that s 307-230 ITAA 1997 currently gives rise to a unintended loophole for members. Some are now arguing that their TRIS retirement phase balances are not counted towards their total superannuation balance (**TSB**) since a TRIS that is in the retirement phase is not expressly referred to in s 307-230(4). This sub-section currently only expressly refers to an ABP. However, the ATO take the view that ABP in s 307-230(4) does include a TRIS. The ATO's current position is causing uncertainty in the industry.	Adopting the auto-conversio resolved.
		Legacy' pensions		
3	ATO & Treasury	Conversion option for 'legacy' pensions	Members should be able to convert market linked pensions (**MLP**) under SISR 1.06(8) and other pre-2007 pensions (such as lifetime, fixed term and flexi pensions) under SISR 1.06(2), (7) and (6)) to an ABP. Preferably members could preserve their Centrelink assets test exemption for such pensions in relation to any replacement ABP. Any such conversions would be subject to the usual transfer balance cap (**TBC**) regime. We imagine that this would have no significant adverse affect on revenue but would provide a significant reduction to compliance costs and provide greater simplicity and flexibility moving forward. Although this only affects a relatively small number of members, it has a significant impact on those members many of whom are in their 'twilight years' and who have great difficulty comprehending the complexity of the 'legacy' products they now have.	Subject to certain integrity n converted to an ABP.
	ATO & Treasury	Capped defined benefit income streams (**CDBIS**)	Legacy pensions amnesty paper which seeks to allow legacy pensions to transition to an ABP and to resolve technical issues with doing so. Similar to above issue.	
4	ATO to change view; if then Treasury to clarify	CDBIS - debits to TBA	ATO view of no debit on commutation of an MLP under s 294-145 of the ITAA 1997	
5	ATO & Treasury	CDBIS & family law commutations	Family law commutations of an MLP under s 294-145 of the ITAA 1997	
6	Treasury	MLPs and seeking a solution for ongoing excess TBC	Dealing with post-30 June 2017 MLPs where the purchase price results in the taxpayer exceeding their TBC and causing a 'continuing in excess' scenario as the law does not allow a commutation unless the ATO can direct one.	
		Reserves		
7	ATO & Treasury	Reserves	Enabling SMSFs to deal with pre-1 July 2017 reserves. The current laws are unsatisfactory for SMSFs that have reserves for historical reasons (eg for lifetime pensions and certain other reasons). For larger reserves, the 5% test and the counting of transfers from a reserve means that not much more than $25K can be transferred to members in any given year. This may mean that it will take many years to transfer some reserves. One possible solution for those with legacy pension reserves is to allow members to transfer these reserves out of the super environment without being counted for contribution cap (**CC**) purposes. Another option is to allow transfers from these pre-1 July 2017 reserves to be counted against the member's non-concessional cap rather than their CC.	One solution is to allow mem super environment without b
			SMSF RB 2018/1 was issued in March 2018 and the industry has still to comment on the ATO's view. Industry has raised its preliminary concern that the ATO is seeking to treat reserves for SISA purposes in a different manner to reserves for tax purposes. Many with legacy pensions previously commuted them pre-July 2017 and still have significant reserves and the ATO position in SMSF RB 2018/1 does not give them any comfort of being able to deal with these reserves in a timely manner.	
8	ATO & Treasury	Operational risk reserve (**ORR**) adjustment	Exclude remediation amounts allocated to member accounts from an ORR from counting as CCs – the resulting taxes on excess contributions could be up to 95% (and further remediation also taxed at 95% to make good that tax). This means the ORR is unfit for the purpose it was intended.	Exclude remediation amoun counting as CCs
9	Treasury	Defined benefit guarantee top-ups	Exclude defined benefit guarantee top-ups from counting as CCs – these were guarantees employers gave often in the 1980s and 1990s well before contribution caps were contemplated that the member would not be worse off by agreeing to move from defined benefit to accumulation accounts (which are cheaper to administer). However, if the guarantees are called on many years later when the employee retires, it can cause an enormous contributions tax liability equal to 95% of the top up (which then requires further top ups that are each taxed at 95%). It mostly affects maritime and construction industry employees.	Exclude defined benefit gua
		Superannuation guarantee (SG)		
10	Treasury	SG - opt out	Broadly, members with incomes above $263,157 with multiple employers will soon be empowered to decide whether certain employers do not need to provide SG contributions in respect of their wages from 1 July 2018 (assuming the May 2018 Budget announcement is enacted). While this is a positive and long overdue measure, we consider that an administrative solution is required given the 1 July 2018 commencement date.	An administrative solution is July 2018 commencement d
11	Treasury	Moderate the penalty regime for late SG contributions	The SG laws should be changed to enable voluntary rectification by employers or to give the ATO the discretion to permit such rectifications. This would allow employers who have made an honest and reasonable error to rectify their error. Employers should be allowed to voluntarily rectify by making late contributions with interest but without any penalty and without lodging an SG statement.SG penalties should be aligned with other taxes. Late contributions should remain tax deductible, continue to be calculated on the basis of ordinary time earnings (not salary and wages). Further, the late payment interest should be the shortfall interest charge grossed up for 15% contributions tax (ie 5.61% rather than the current 10% which is excessive) and be calculated from the 28 th day after the end of the quarter (not the start of the quarter) until the payment is made (ie not until when the SG statement is lodged). Director liability, criminal sanctions and imprisonment for errors and insolvency are unreasonable unless these are confined to the extreme cases. SG statements should no longer be required given single touch payroll reporting and the $20 administration fee should only be charged where the late contributions are paid to ATO for it to disburse to employees' superannuation.	
12	Treasury	SG 'notional earning base'	Reinstate the SG 'notional earning base' for employees covered by industrial instruments so that pay components on which SG is owed can be clearly bargained for thereby reducing the current level of SG litigation and disputes, and ensure that where employees are paid. annualised or aggregated pay rates designed to cover all industrial entitlements that the underlying pay components are still recognised	Reinstate the SG 'notional e instruments.
			The recent Federal Court decision in Australian Workers' Union v BlueScope Steel (AIS) Pty Ltd [2018] FCA 80 has important implications for when employers need to pay superannuation contributions to employees in respect of additional hours and public holidays. The Federal Court held that the employer should have made SG contributions in respect of the "additional hours" and "public holidays" components of salaries under the terms of the agreement between BlueScope Steel and its employees where the employees were required to work additional hours as well as work on public holidays. The Bulk Operations Enterprise Agreement 2005 (for example) requires employees to work "additional hours" and on "public holidays" as the norm that underpins the recognition that those employees can only fairly be remunerated by reference to an 'annualised salary', said Federal Court judge, Justice Geoffrey Flick. Broadly, this case resulted in additional hours of work to being treated as ordinary time earnings (**OTE**) despite the Enterprise Agreement between the company and its employees suggesting they were additional hours. The Court said hours which are worked beyond standard or fixed hours may become such that they become the "ordinary hours" of an employee. This case has potentially wide spread ramifications and the concept of 'OTE' for SG purposes may result in a considerable number of other employees now being exposed to SG on the amount of salary and wages they pay to their employees rather than just OTE.	OTE should not cover additi
13	Treasury	Expat employee SG clarification	Clarify that SG is not applicable to expatriate employees on wages that are not subject to PAYG withholding	Exclude wages paid to expa from SG.
		Foreign fund transfers to Australian super funds		
14	Treasury	Foreign fund transfers to Australian super funds	Fixing up the current regime for foreign fund transfers to Australian super funds. While there is some difficulty achieving the right balance between facilitating this and fitting within Australia's restrictive superannuation regime. One option would be to treat foreign fund transfers as a special form of contribution with a special cap – similar to the ability to make contributions under the capital gains cap (small business tax concessions). This could be capped to people who have total super balance of less than $1.6 million. Also the eligibility for foreign funds should be widened (eg to include certain USA 401k funds that may not currently qualify).	Provide more flexibility subje savings from foreign super f
			We would prefer to focus on more alignment with UK transfers rather than US transfers	
		Sundry technical issues		

15	Treasury	Residency status for SMSFs	An SMSF can easily fail the 'Australian superannuation fund' test in s 295-95(2) ITAA 1997 with substantial tax implications. There is currently no ATO discretion to allow the Commissioner to ignore such failures. Therefore, the test needs to be made more appropriate for SMSFs as the current tests are difficult and have no flexibility if breached. Further, if an SMSF is rendered non-complying as a result of failing the 'Australian superannuation fund' test, there is a further tax penalty on such a fund gaining its 'Australian superannuation fund' test residency back. In these circumstances, why would such a fund want to resume being an 'Australian superannuation fund' test only to receive another tax penalty.	Delete the need for the activ management and control tes
16	Treasury & ATO	Notices of deduction of personal contributions	The requirements for **notices of deduction** of personal contributions should be simplified and greater flexibility provided. For example, relief needs to be provided when mistakes are made in completing the notices especially as more notices will be used given the abolition of the 10% employee test. The ATO have been working on a proposal where the member can claim the deduction in their personal tax return and the fund is then notified to adjust for any tax payable. The integrity measures announced in the May 2018 Budget may partially resolve some of these issues.	
17	Treasury	Untaxed element calculation triggered on a rollover of a death benefit	We submit that the untaxed element in s 307-290 ITAA 1997 should be deleted in respect of taxed superannuation funds given the mid-2017 legislative changes and particularly given the reduced opportunity for claiming insurance in SMSFs. If however the untaxed element is not removed, then at least the calculation triggered on a rollover of a death benefit to commence an income stream with another provider requires adjustment so no untaxed element arises on roll-over. Broadly, this will result in largely only public sector funds only having to deal with an untaxed element.	
18	Treasury	Binding death benefit nominations (**BDBN**)	The SISA/SISR provisions relating to BDBNs are according to the *Retail Employees Superannuation Pty Ltd v Pain* [2016] SASC 121 case unworkable and in urgent need of repair. This case contains extensive commentary on the BDBN provisions in the SISA and SISR by the SA Supreme Court. The court called for reform in this area at [512]: The structure and drafting of sections 58 and 59 of the SIS Act and regulation 6.17A of the SIS Regulations give rise to ambiguities, uncertainties and potentially unintended consequences … It is highly desirable that those provisions be reviewed by the Commonwealth and recast. There are now two supreme court decisions that confirm the view that the SISA/SISR provisions regarding BDBNs do not apply to SMSFs provided the deed is appropriately worded (refer: *Munro v Munro* [2015] QSC 61 and *Cantor Management Services Pty Ltd v Booth* [2017] SASCFC 122). Many SMSF deeds are not appropriately worded and as a result most BDBNs simply do not stand up to any legal challenge. Further, many BDBNs do not work for both large and SMSFs and consumers have BDBNs that do not work. Further, recently ASIC found many financial planners backdating and signing BDBNs when they were not present at the execution by the client. Lawyers should be the only ones who can provide legal advice and legal documents affecting the legal rights of members. Non-legally qualified persons should refrain from seeking to prepare SMSF deeds and BDBNs unless they are qualified under the relevant state or territory in which the service is rendered. The Australian Law Reform Commission also recommended, among other things, that an attorney under an enduring power of attorney should not be able to vary a member's BDBN and an annual disclosure/review in relation to a member's succession be considered.	Provide clarity that the BDBI undermined by legal challen
18A	ATO	Making an ABP auto-reversionary via a BDBN	Making an ABP automatically reversionary via a BDBN	Confirm the ability for a BDE comments in LCR 2017/3 pa
19	Treasury	Non-geared unit trusts & companies		Greater flexibility provided fo of SISR
20	Treasury & ATO	Life interest pensions	An SMSF can invest in a SISR 13.22B & 13.22C non-geared unit trust or company provided certain criteria is satisfied. However, if any criterion is contravened the units or shares acquired under that relief will cease to be covered by the exception and will become an in-house asset. This may arise for a range of issues and the downside of contravening far outweighs the nature of the breach which may be minor and an honest oversight. For example, having an unpaid present entitlement for more than 12 months, going slightly into overdraft due to a bounced cheque or for a debit loan due to a related or third party paying an expense on behalf of the unit trust or company. The downside of these technical breaches is far too onerous and some flexibility should be provided to rectify within a given period.	Recognise life interest pens
			Life interest pensions - broadly to allow pensions to revert to a surviving spouse and then for any remaining capital to go to children from a former relationship.	

APRA Fund items

Treasury	Div 310 fund merger relief	
Treasury	Div 311 partial fund merger relief	Make the relief for asset and loss rollover permanent and extend it to preserve tax losses attributable to superannuation members in underlying captive managed investment trusts Broaden the relief to all partial fund mergers so it can, for instance, apply when a dealer group wishes to change the superannuation fund it is allied to without tax blockers (superannuation industry participants should not be punished due to the business model they have adopted, there should be a level playing field)