SUBMISSION

Submission to Australian Taxation Office — PCG 2019/D2 *Compliance approach in respect of pension tax bonuses not included in opening account balances*

14 August 2019

The Association of Superannuation Funds of Australia Limited
Level 11, 77 Castlereagh Street
Sydney NSW 2000

PO Box 1485
Sydney NSW 2001

T +61 2 9264 9300
1800 812 798 (outside Sydney)
F 1300 926 484
W www.superannuation.asn.au

ABN 29 002 786 290 CAN 002 786 290

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Mr Ricardo Coburn

Director, Public Groups

Australian Taxation Office

Via email: Ricardo.Coburn@ato.gov.au

14 August 2019

Dear Mr Coburn

PCG 2019/D2 Compliance approach for large APRA-regulated superannuation funds in respect of pension tax bonuses not included in members' opening account balances on commencement of a pension

The Association of Superannuation Funds of Australia (ASFA) is pleased to provide this submission in response to the ATO's consultation on its draft practical compliance guideline PCG 2019/D2 *Compliance approach for large APRA-regulated superannuation funds in respect of pension tax bonuses not included in members' opening account balances on commencement of a pension* (PCG 2019/D2).

About ASFA

ASFA is a non-profit, non-political national organisation whose mission is to continuously improve the superannuation system, so all Australians can enjoy a comfortable and dignified retirement. We focus on the issues that affect the entire Australian superannuation system and its $2.8 trillion in retirement savings. Our membership is across all parts of the industry, including corporate, public sector, industry and retail superannuation funds, and associated service providers, representing almost 90 per cent of the 16 million Australians with superannuation.

ASFA's submission has been prepared with the assistance of our Tax Specialist Advisory Committee. The Committee has identified a number of concerns in relation to the draft guideline, as outlined overleaf.

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If you have any queries or comments in relation to the content of our submission, please contact me on (03) 9225 4027 or jstannard@superannuation.asn.au.

Yours sincerely

Julia Stannard

Senior Policy Officer

General comments

Given the increasing interest in the introduction of pension tax bonuses (PTBs) by large Australian superannuation funds, ASFA welcomes the release of PCG 2019/D2 and the transitional compliance approach that it proposes.

This submission focuses on the conditions set out in PCG 2019/D2 (as per paragraph 13) that the ATO is proposing that a fund must satisfy in order to avail itself of this transitional compliance approach.

However, ASFA also notes that:

- the transitional compliance approach may not be relevant if APRA's views as to the inclusion of PTBs in a member's initial balance were to differ from those assumed by the ATO
- while discussions between funds and the ATO in relation to PTBs have sought the ATO's views on a number of tax-related issues, PCG 2019/D2 addresses only one of these. It is likely that PCG 2019/D2 will be of limited value to the industry unless these other issues are addressed. This is particularly the case for the many funds whose administration systems are already fully capable of calculating minimum pensions in accordance with the ATO's view.

Our submission also addresses these additional matters.

Conditions in paragraph 13

ASFA has concerns regarding a number of the conditions that must be satisfied in order for the compliance approach to apply, as outlined in paragraph 13 of PCG 2019/D2.

Engagement with APRA – paragraph (d)

ASFA submits that the condition in paragraph 13(d) that a fund has notified APRA of the potential breach of the minimum pension payment standards may be limiting in some circumstances. ASFA's understanding is that, in respect of the PTBs introduced to date, the decision as to whether to liaise with APRA in respect of these issues has varied from fund to fund.

It would also be useful if the ATO could provide additional comment on the nature of the notification to APRA that would meet the proposed condition. Of the funds that have liaised with APRA in respect of their PTBs, ASFA is not aware of any that have notified APRA of the potential breach. Rather, some funds have sought APRA's view as to the manner in which Schedule 7 to the *Superannuation Industry (Supervision) Regulations 1994* (SIS Regulations) is to be interpreted (noting that this schedule sets out the rules for the calculation of the minimum pension).

More generally, as noted in the "Minimum pension requirement" section below, APRA has the power in Part 29 of the *Superannuation Industry (Supervision) Act 1993 (*SIS Act) to provide an exemption or modification to the requirements in the SIS Regulations, including to the minimum pension rule in Schedule 7. If a fund was to notify APRA and obtain APRA's assurance that it was comfortable with the fund's proposed approach, it may be queried whether the ATO's guidance is then redundant — at least in relation to the present iteration that is limited to the minimum pension issue.

Maximum PTB – paragraph (e)

ASFA submits that the condition in paragraph 13(e) that the PTB cannot exceed 1.5 per cent of a member's account is arbitrary and not consistent with the proportion that the deferred tax liability (DTL) represents of the net asset position for many funds.

A PTB is broadly designed to provide a member with his or her share of the fund's DTL that ceases to exist upon the commencement of a pension.

For reasons of either simplicity or conservatism, the business rules for the PTBs introduced or being considered by a number of funds have often capped the level of the PTB. However, in practice, quantum of a fund's DTL can often exceed 1.5 per cent of a fund's net asset value. Using a 10 per cent tax rate (that is, assuming all or most of the fund's assets have been held for more than 12 months), a 1.5 per cent DTL equates to an average 15 per cent increase in market value in the fund's assets since their original acquisition date.

This is particularly so for any of a fund's investment options that are exposed to higher growth assets.

By way of illustration, assume that, at a particular point in time, the net asset value of a fund's Australian equity option was $500 million, comprised of:

- gross market value of Australian equities $520 million; less
- DTL of $20 million (reflecting unrealised capital gains of $200 million, that has accrued over a number of years since the option commenced with Australian equities acquired for $320 million.

The appropriate share of a member in the DTL for a member who has been in this option since inception is 4 per cent (that is, $20/$500). The size of the PTB attaching to this member's account, should he or she transfer to pension phase, could accordingly be up to 4 per cent of his or her accumulation balance. The trustee of a fund may not wish to apply a cap of 1.5 per cent to this member, as the trustee may determine that such a cap for this member (and other similar members) would not be equitable under the rules that it establishes for the PTB.

ASFA submits that either the present 1.5 per cent maximum in paragraph (e) should be removed entirely, or that it should be increased to a level consistent with the level of the DTL that may accrue within funds and in specific investment options within funds.

Quantum of the PTB – paragraph (f)

ASFA submits that the condition in paragraph 13(f) that the PTB be "*representative of the member's investment options during the accumulation phase and proportionate to the time they have been a member of the superannuation fund*" is inconsistent with the cap in paragraph (e). As noted in the example above, the level of PTB that would appear to satisfy this condition would be equal to 4 per cent of his or her accumulation balance. If the fund were to reduce this to the proposed cap of 1.5 per cent, would the fund be required to similarly reduce the PTB for all other members? Similarly, if a cap was applied, should this reduce all PTBs above 1.5 per cent equally to 1.5 per cent, or should the relativities between the two members' contribution to the fund's overall DTL be maintained?

For example, if the equivalent calculation for another member was 1.6 per cent, should both be equally reduced to 1.5 per cent, or should the PTB for the member with prima facie 4 per cent be reduced to 1.5 per cent, and then (on a relative basis), the PTB for the member with prima facie 1.6 per cent be reduced to 0.6 per cent (that is, 1.5 per cent x 1.6/4.0)? If so, this would result, for any fund with a high growth option such as Australian equities, in the PTB for many members being capped at a level well below 1.5 per cent (which would apply only to the members within the investment option with the highest relative share of the fund's DTL).

ASFA further submits that this condition unnecessarily restricts the development of business rules by funds based on their particular circumstances, and that this restriction does not seem to serve any broader policy objective. For example, there will be funds that may choose to apply the same sized PTB to all transferring members (perhaps with the sole exceptions of wholly revenue options such as cash or bonds). This may be done for reasons of simplicity or systems limitations in calculating different proportionate PTBs for each separate investment option. The determination of the manner in which a fund chooses to allocate the reduction in DTL to its different cohorts of members should be a matter for each fund based on its particular circumstances. There would appear to be no ATO or broader policy objectives in limiting the development by fund trustees of business rules that are appropriate to those funds' circumstances.

Propagation arrangements – paragraph (g)

ASFA submits that the condition in paragraph 13(g) should be clarified such that this condition would not be required to be met by funds that have obtained private binding rulings in respect of their propagation arrangements (even if the features of those arrangements did not meet every one of the requirements in PCG 2018/2 *Propagation arrangements adopted by registrable superannuation entities*). For funds that have obtained such a ruling, there would appear to be no circumstance in which the ATO could require changes to the propagation outcome that could then result in the available reduction in the DTL (and thus the available PTB) also changing.

Recommendation
Conditions for application of the compliance approach The conditions for application of the compliance approach, as outlined in subparagraphs PCG 2019/D2 (d) - (g), should be clarified.

Limited scope of the guidance

In introducing a PTB, ASFA is of the view that the three main tax-related issues are:

1. whether reporting for the purposes of the transfer balance cap is of the member's balance including or excluding the PTB
2. whether the amount of the PTB, when credited to a member's account, should be treated as a transfer of a fund's reserves — and thus potentially count as a concessional contribution for the purposes of the concessional contributions cap
3. whether the calculation of a member's minimum pension in the first year should be based on the member's balance including or excluding the PTB.

PCG 2019/D2 is restricted solely to the last and arguably the least controversial of these issues. It makes limited reference to the first issue in paragraph 10 without providing the basis for the ATO's conclusion on this issue, and makes no reference at all to the second issue.

In essence, the draft guidance appears to be similar in its focus to PCG 2017/3 *Income tax - supporting the implementation of the changes to the taxation of transition to retirement income streams*, insofar as it appears to deal primarily with issues arising from systems limitations at funds and/or their administrators. Accordingly, whilst PCG 2019/D2 will be of value to those funds whose administration systems are presently limited in the manner in which they can deal with PTBs for the purposes of calculating the minimum pension for the first year, it will be of limited value to funds whose administration systems are not limited in this way.

ASFA submits that, given the increasing use of PTBs within the industry, and the broader range of tax-related issues that may arise, what is needed by the industry is guidance that goes beyond these systems-related issues.

Recommendation

Scope of the guidance

The scope of PCG 2019/D2 should be widened beyond system-related issues, to address other tax-related issues in relation to pension tax bonuses.

Minimum pension requirement

ASFA submits that, as well as being limited, the focus of the draft guidance solely on the minimum pension requirement, may not be within the purview of the ATO.

In particular, as noted in the draft guidance, the minimum pension requirements are set out in Schedule 7 of the SIS Regulations. Except in relation to self-managed superannuation funds (SMSFs), the relevant authority in respect of these requirements is APRA and not the ATO.

It is true that, if APRA were to opine that the minimum pension requirement should be based on a member's balance including the PTB, and the member did not receive this minimum pension in a particular year:

- the portion of the fund's superannuation liabilities relating to that member could not be counted as part of the "average value of current pension liabilities" for the purposes of the formula in section 295-385 of the *Income Tax Assessment Act 1997* (ITAA 1997); and
- this would have consequences to the calculation of a fund's income tax liabilities that are within the ATO's purview.

Paragraph 8 of the draft guidance appears to assume the minimum pension requirement is based on a member's balance *including* the PTB. However, it does not cite any publicly stated view by APRA on this matter, and to our knowledge APRA has expressed no such public view.

If APRA were to publicly express the view that the minimum pension requirement should be based on a member's balance *excluding* the PTB, or if APRA were to release an exemption or modification under Part 29 of the SIS Act to this effect, the draft guidance would then be redundant (unless it was expanded to also address the other tax issues associated with PTBs).

Accordingly, ASFA submits that, prior to the draft guidance being finalised, the ATO should liaise with APRA to determine whether paragraph 8 is consistent with APRA's view as to the inclusion or exclusion of the PTB in a member's balance for the purposes of calculating the minimum pension requirement, and that the public statement by APRA of its views on this matter should be a precursor to the finalisation of the ATO's views as expressed in the draft guidance.

Recommendation

Minimum pension requirements

The ATO should liaise with APRA, prior to finalising the guidance, to ensure consistency with APRA's view regarding the treatment of a pension tax bonus for the purpose of calculating the minimum pension requirements under the *Superannuation Industry (Supervision) Regulations 1994*.

Concessional contributions cap

ASFA considers it would be helpful if the guidance was expanded to cover the concessional contributions cap aspects, including 'safe harbour' indicia based on the different fact patterns in the private ruling requests issued on this matter to date (per authorisation numbers 1051333982647, 1051269858014 and 1012851212407).

Broadly, the conclusions in those private rulings seem to be distinguishable on the basis that:

- arrangements where it can be demonstrated that the quantum of the PTB is funded through a fund's periodic tax alignment or true-up processes will *not* count as concessional contributions
- in contrast, arrangements where the quantum of the PTB is funded from a fund's reserves (of whatever kind) *would* seem to count as concessional contributions.

It would be helpful if the guidance were to state whether this is a correct summary of the ATO's views on this matter, or if not, to provide ATO guidance as to the circumstances in which the provision of the PTB will count towards a member's concessional contributions cap.

In the absence of such guidance, it is likely that trustees of funds introducing PTBs will continue to seek individual rulings from the ATO on this issue (as they did with the propagation issue prior to the release of PCG 2018/2).

Recommendation

Concessional contributions cap

The guidance should be expanded to cover the circumstances in which the provision of the PTB will count towards a member's concessional contributions cap.

Transfer balance cap

As noted above, the guidance does not seem to provide the basis for the ATO's conclusion in paragraph 10 that "*the amount of the transfer balance credit will incorporate the value of the pension tax bonus as part of the value of the superannuation interest*".

Footnote 8 in this paragraph refers to table item 2 in subsection 294-25(1) of the ITAA 1997. However, this subsection uses the term '**value*' which means that 'value' is a defined term. Section 995-1 of the ITAA 1997 defines 'value' of a superannuation interest as having the meaning in subsection 307-205(1). In turn, in the absence of regulations to the contrary, subsection 307-205(1) defined the 'value' of a superannuation interest as "*the total amount of all the superannuation lump sums that could be payable from the interest at that time*".

'Value' for the purposes of subsection 294-25(1) is required to be calculated on the starting day of the superannuation interest that supports the pension.

The rules for the PTBs introduced by a number of funds include a 'clawback' such that the PTB does not form part of a lump sum payout to a member if he or she commutes the pension within a given period (typically within the first 12 months after the pension commences).

Accordingly, where a clawback applies, the total amount of all the superannuation lump sums that could be payable from the superannuation interest on the date of commencement of the pension *would not* include the amount of the PTB.

ASFA submits that the draft guidance should be expanded to appropriately articulate the basis for the ATO's conclusion in paragraph 10 that the amount of the transfer balance credit will incorporate the value of the PTB as part of the value of the superannuation interest.

Recommendation

Transfer balance cap

The draft guidance should be expanded to address in more detail the ATO's conclusion regarding the treatment of pension tax bonuses for the purpose of the transfer balance cap.

Whilst the technical basis for the ATO's view in paragraph 10 is unclear, ASFA is sympathetic to this view from a tax policy perspective, as this treatment would appear to align with the outcome that would occur for a single member in a SMSF. In a SMSF, any accrued DTL would cease to exist upon the transfer of the member from accumulation phase to pension phase. In these circumstances, the only possible amount to be reported as the transfer balance credit would be the net assets of the SMSF without regard to this DTL.

However, the ATO's position creates some potential difficulties in a large fund context, compared to that for an SMSF, where the member does commute the pension during the clawback period.

By way of illustration, assume that the final balance for a member in a large fund prior to the commencement of a pension was $500,000, and that the PTB was $6,000. Based on the ATO's view, the fund would report the amount of $506,000 as the transfer balance credit. If the member was shortly thereafter to change his or her mind and commuted his or her account, the operation of the clawback would mean that the commutation lump sum would be $500,000, and this would seem to be the transfer balance debit pursuant to table item 1 in subsection 294-80(1). Thus, the member would have a net transfer balance credit equal to the PTB of $6,000, despite not having any part of his or her account in pension phase. This would, in ASFA's view, be an anomalous outcome.

It is noted that no such issues arise for an SMSF because, in equivalent circumstances, the commutation lump sum would be $506,000 (if the $6,000 was the DTL in the SMSFs accounts for the member immediately before commencement of the pension).

ASFA submits that the draft guidance should be expanded to address how fund trustees should deal with this potential anomaly in relation to the reporting of transfer balance credits and debits. For example, if the fund reports the higher balance for transfer balance credit purposes (in accordance with the ATO's view), should the fund also be entitled to report as the transfer balance debit the commutation lump sum plus any forfeited PTB in any circumstances where the clawback is applied?

Recommendation

Subsequent commutations

The draft guidance should be expanded to address how fund trustees should deal with a potential anomaly in relation to the reporting of transfer balance credits and debits.