The Association of Superannuation Funds of Australia Limited
ABN 29 002 786 290
ASFA Secretariat
PO Box 1485, Sydney NSW 2001
p: 02 9264 9300 (1800 812 798 outside Sydney)
f: 02 9264 8824
w: www.superannuation.asn.au

25 January 2017

Jenny Wilkinson
Retirement Income Policy Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: jenny.wilkinson@treasury.gov.au

Dear Ms Wilkinson,

RE: Capital Gains Tax Rollover Relief for Mergers of Superannuation Funds

The Association of Superannuation Funds of Australia (ASFA) would like to lodge this submission with respect to the need for permanent capital gains tax (CGT) rollover relief for mergers of superannuation funds.

ASFA is a non-profit, non-political national organisation whose mission is to continuously improve the superannuation system so people can live in retirement with increasing prosperity. We focus on the issues that affect the entire superannuation system. Our membership, which includes corporate, public sector, industry and retail superannuation funds, plus self-managed superannuation funds and small APRA funds through our service provider membership, represents over 90 per cent of the 14.8 million Australians with superannuation.

Executive summary

ASFA is strongly supportive of the superannuation industry that is competitive and that is continuously improving its efficiency and productivity. Consolidation/mergers can be a means by which funds can realise scale efficiencies.

In our response to the Productivity Commission's *Superannuation Efficiency and Competitiveness Issue Paper* ASFA identified the absence of ongoing CGT relief as a significant barrier to fund consolidation/mergers. The triggering of CGT events when implementing a merger, which results in the realisation of otherwise unrealised gains and the inability to carry forward losses, can prevent a trustee from entering into a fund merger.

In determining whether to merge with another fund, a trustee of a superannuation fund is under a fiduciary duty to act in the best interests of the members of the fund. As such, the threshold decision as to whether or not to merge is made taking into consideration the various benefits and costs to members of the potential merger – this includes the effect of CGT.

In our submission to the Productivity Commission, ASFA identified that, depending on the volatility of the market, after a downturn a fund can carry deferred tax assets of an amount equivalent to 1.5 per cent or more of member account balances, the benefit of which would be lost if a merger were to go ahead without CGT relief. For a member with an average account balance of approximately $70,000, this could represent a reduction in the value of their superannuation account of over $1,000. In such circumstances, the absence of CGT rollover relief may cause the costs to members, through the extinguishment of deferred tax assets, to outweigh the benefits of any proposed merger.

<u>Implications of the lack of CGT relief</u>

ASFA consistently has supported the position that the tax legislation should provide permanent CGT relief for mergers of superannuation funds, equivalent to that in Division 310 of the *Income Tax Assessment Act 1997* ("ITAA97"), in a number of previous submissions to Government.

The reasons ASFA holds this view include:

1 As discussed above, the absence of permanent relief continues to present a significant barrier to consolidation within the industry. This barrier is virtually insurmountable during any periods where the closing fund's balance sheet is in a deferred tax asset ("DTA") position, and continues to be a potential impediment in present times where the closing fund's balance sheet is in a deferred tax liability ("DTL") position.

2 The absence of permanent relief means that this issue must consistently be revisited, and typically temporary relief provided by Government, in conjunction with any Government initiatives to encourage consolidation or efficiency within the superannuation industry. The present position has the potential to create significant inequities between members of funds that merge during periods when there is relief and members of funds that merge during periods when there is no relief.

3 From a revenue perspective, it is not considered that permanent relief would be an overall cost to revenue, as a more efficient industry should deliver higher revenues and broader economic benefits to the community over time.

4 Permanent relief would be consistent with the broad structure of Australia's CGT provisions, as comparable relief is available to corporate mergers and for a range of other business reorganisations.

ASFA addresses each of these issues in greater detail in the body of the submission below.

Detailed comments

Pending expiration of the present relief

The urgency of this issue, and the need for it to be considered at the appropriate levels within Treasury, Government and the regulators of the industry (i.e., APRA, ASIC and the ATO), is that the present relief expires on 1 July 2017, such that a merger of funds occurring on or after 2 July 2017 will not qualify for the relief.

History of the present relief

Whilst the history of the present relief dates back to times when the closing fund's balance sheet was more likely to be in a DTA position, potential tax costs to a fund's members remain relevant in present times when the closing fund's balance sheet is more likely to be in a DTL position.

The present relief dates back to December 2008, during the global financial crisis, when the absence of relief would have resulted in a permanent detriment to fund members.

This permanent detriment occurs due to the permanent loss of the tax benefit associated with any unutilised carried forward capital or revenue losses in the closing fund, and this presents a virtually insurmountable barrier to mergers.

The present relief in Division 310 was originally scheduled to expire on 30 June 2011, subsequently extended to 30 September 2011.

The relief, however, was then reinstated for the period 1 July 2012 to 1 July 2017 to recognise that funds may close as a consequence of the introduction of the MySuper rules (to the extent that a fund did not choose to obtain a MySuper licence) and that the absence of relief could impose a significant burden on funds and fund members.

Similar relief previously was provided to promote industry consolidation and to provide relief as trustees transitioned to the SIS and RSE licensing regimes (for example the relief in former subdivision 126-F of ITAA97, which provided relief during the period between 30 June 2004 and 1 July 2006 where the closing fund's trustee was not going to seek an RSE licence).

The more common present circumstance, where the closing fund's balance sheet is in a DTL position, means that the potential effect is a timing rather than permanent detriment. This timing detriment, however, still represents a clear cost to a fund's members from a merger (as detailed in the following section), and therefore acts as a potential impediment to mergers proceeding.

Absence of relief would continue to present a significant barrier to consolidation within the industry

Even with the existing relief, the pace of consolidation in recent years within the industry has been slow. Removal of the relief would represent an impediment that would be likely to slow further the pace of consolidation.

It is likely that, if present and future Government reviews of superannuation (for example the present Productivity Commission review) recommend further measures to achieve consolidation within the industry, potentially affected funds will again seek CGT relief to the extent that CGT considerations act as an impediment to the successful implementation of these measures.

In the implementation of any future efficiency measures, Governments will be required on each occasion to reconsider whether another round of temporary CGT relief is warranted as part of the particular measures.

The need for relief may be particularly relevant in circumstances where a closing fund is in an overall DTA position, as the inability of the closing fund to transfer the effective value of the DTA to the ongoing fund represents a permanent loss of value for the closing fund's members.

Given that the fund trustees are required by law to conclude that the merger is in the best interests of their members, and the closing fund is more likely to be in overall DTA position than the continuing fund, it will need to ensure that the merger is in the interests of their members.

In this sense, the absence of CGT relief may be a greater impediment to industry consolidation for funds which are in an overall DTA position, notwithstanding the benefit to their members that such a consolidation would deliver.

Nonetheless, the need for relief is not restricted to closing funds in overall DTA positions. The absence of permanent relief also acts as an impediment to mergers in the more common present circumstance where funds are in DTL positions. This is because, for these funds, the transfer of assets to the ongoing fund will crystallise the entirety of the funds' then unrealised capital gains (which underlie the DTL positions).

This results in tax becoming immediately payable that would not otherwise have been payable until these assets were sold in the ordinary course of business. This may have been some years into the future, as many funds still experience significant net cash inflows and thus are not compelled to dispose of assets in the ordinary course of business. This acceleration of the point at which tax is paid on these unrealised capital gains in a merger results in a significant cash flow disadvantage, which is borne by the members of the closing fund. The closing fund trustee would need to consider this disadvantage as it weighs up the overall costs and benefits of a potential merger.

It is in the interests of the entire industry that mergers occur when they are in the best interests of the members. It is in nobody's interest that funds choose not to merge in circumstances when they might otherwise choose to merge because of CGT, and instead choose to wait until such time as the next version of temporary relief is legislated.

Government initiatives & economic downturns prompt revisiting of ad hoc temporary relief

The provision of permanent relief would ensure that, as best as is possible, mergers occur at the earliest point in time at which they are determined as being in the best interests of members and are not delayed until such time as temporary relief is granted and the merger becomes feasible.

The present position has the potential to create significant inequities between members of funds that merge during periods when there is relief and members of funds that merge during periods when there is no relief because, notwithstanding the effect of CGT, the benefits exceed the costs.

As noted above, history has shown that the introduction of significant regulatory changes within the industry have usually been accompanied by temporary CGT relief for fund mergers. The only instance where it has not been regulatory change which has been the rationale for the granting of temporary CGT relief is the relief commencing in December 2008 that formed part of the Government's specific response to the global financial crisis.

Where the CGT cost to members' balances is too large it is likely that mergers will not proceed at all, as it is likely that the closing fund trustee will be unable to conclude that the merger is in the best interests of the fund's members.

Nonetheless, whilst the absence of CGT relief can act as a significant impediment to fund mergers, it is possible that mergers may occur during periods where no relief is available. Specifically, there may be a level of cost where the closing fund trustee still may conclude that a merger is in the best interests of the fund's members.

If a merger occurs in these circumstances, however, there is a significant equity issue for the Government to consider, particularly as successor fund transfers are by their very nature undertaken without member consent. In particular, the question should be asked as to why members whose funds are merged outside a period when temporary CGT relief is available should suffer a cost to their balances, as compared to those members whose funds are merged during a period when such relief is available.

Permanent relief would not be a cost to tax revenue

ASFA submits that permanent relief would not be cost to revenue, as a more efficient industry should deliver higher revenues and broader economic benefits to the community over time.

In particular, the likely outcomes from industry consolidation are:

- Lower expenses incurred within the combined fund than those presently incurred in the two separate funds. This translates to lower deductions claimed by the merged fund, compared to those claimed in the two separate funds, and thus to higher taxes being payable

  and/or

- Higher investment returns achievable within the combined fund than those achievable in the two separate funds, due to greater scale and/or greater capacity to make investments in asset classes providing higher returns (for example, infrastructure, unlisted property, private equity, etc). This translates to higher assessable income from investments in the merged fund, compared to that in the two separate funds, and thus to higher taxes being payable.

In addition, larger funds can better participate in infrastructure and similar projects, which have the potential to create broader economic benefits to the community, including the employment created in the construction phase and ongoing productivity gains to the economy. These broader productivity gains may also be expected to deliver higher revenue over time.

To the extent that mergers still occur in the absence of CGT relief, tax revenue is brought forward in respect of the closing fund's then unrealised capital gains. For closing funds in net DTA positions, mergers are less likely to occur at all but, if they do, tax revenue in future years increases due to the ongoing fund being unable to use the combined realised and unrealised capital losses that would have been available for use by the closing fund had it continued to exist.

ASFA submits, however, that these timing effects on tax revenue are unlikely to outweigh the higher taxes that may be expected to flow from the superannuation industry being as productive and efficient as policy settings will allow.

Firstly, if these timing effects on tax revenue are sufficiently large, it is highly likely that the particular merger will not occur, or will be deferred until the next period in which temporary CGT relief is available. This is because, in such circumstances, the cost to the closing fund's members is equivalently large, and it is highly likely that the closing fund trustee will be unable to conclude that the merger is in the best interests of its members.

Secondly, the effects on tax revenue from any actual fund mergers during periods of no CGT relief are timing effects only. That is, this tax will have been paid in any case when the relevant assets of the closing fund were disposed of in the ordinary course. In contrast, the higher taxes that may be expected to flow from efficiency gains within the superannuation industry are permanent and enduring.

Permanent relief would be consistent with the broad structure of Australia's CGT provisions

Permanent relief would be consistent with the broad structure of Australia's CGT provisions, as comparable relief is available to corporate mergers and for a range of other business reorganisations.

When CGT was first introduced in 1985 it was recognised that there was a broad range of business reorganisations that may result in prima facie changes in the legal or beneficial owner of an asset, but where relief was appropriate as there was no actual change in the underlying ownership.

In 1985 superannuation funds were not yet subject to tax, only becoming so in 1988.

In addition, Australia's superannuation industry was in its infancy in 1985. Productivity superannuation contributions did not commence until 1986 and mandatory superannuation for most employees did not commence until the Superannuation Guarantee legislation was introduced in 1992.

In this context, it is not surprising that, when the CGT was introduced, the merger of superannuation funds was not considered as a similar situation where the legal ownership of assets may change (i.e. from the trustee of the closing fund to the trustee of the ongoing fund) but there was no actual change in underlying ownership (i.e. the assets of the ongoing fund are then held for the benefit of the combined membership of the closing fund and the ongoing fund).

Within the broad range of business reorganisations for which CGT relief is provided, there are a number that share features with a merger of superannuation funds:

1. Subdivision 122-B provides for CGT relief where partnership interests are transferred to a wholly owned company. For example, a partnership with 2 partners holding 70% and 30% interests respectively can transfer these interests (and the relevant underlying assets held by the partners in respect of the partnership) to a company in which they hold 70% and 30% of the shares respectively.

   This is essentially similar to the merger of two superannuation funds, if this were facilitated by the formation of a new superannuation fund to which the members and assets of both of the existing funds were transferred. Whilst this is not the usual manner in which a merger of two superannuation funds is undertaken, it is noted that, even if the merger were undertaken in this way, no equivalent CGT relief would be available.

2. Subdivision 124-M provides scrip for scrip CGT rollover relief for corporate mergers. For example, in (say) a corporate takeover, the shareholders in a company can receive shares in another company in replacement for their present shares, without triggering a disposal for CGT purposes. Instead, the shareholders' cost base of the present shares becomes the cost base for the replacement shares, and a taxable CGT event then only occurs on the disposal of the replacement shares.

   Following a scrip for scrip takeover, the former shareholders of the target company become shareholders of the acquiring company. From a legal perspective, the target company becomes a subsidiary of the acquiring company. From a tax perspective, however, in conjunction with the tax consolidation rules, the assets of the target company and those of the acquiring company become a single group of assets held by the tax consolidated group, held and utilised for the benefit of the combined group of shareholders.

   This outcome is directly comparable to the outcome in a superannuation fund merger, where the assets of the closing fund and the assets of the ongoing fund become a single group of assets held by the merged fund, held and utilised for the benefit of the combined group of members.

ASFA submits that appropriate distinction can be drawn between CGT relief for taxpaying entities, such as corporates and superannuation funds, and that for non-taxpaying entities, such as managed investment trusts.

Technically, managed investment trusts ("MITs") can also access the Subdivision 124-M relief for scrip for scrip transactions, though superannuation funds cannot (as they do not have scrip). In practice, however, the absence of tax consolidation rules for MITs means that transactions where MITs may access the subdivision 124-M relief are not common.

In any case, there are some clear distinguishing features between a superannuation fund merger and a merger of two MITs. These features both point to a superannuation fund merger being more akin to a merger of corporations than is a merger of MITs.

Firstly, a superannuation fund is a taxpayer in its own right in Australian tax legislation, in a similar way to a corporation, with a single tax profile. In contrast, a MIT is a "transparent entity" for Australian tax purposes, and the unit holders in a MIT may include individuals, corporations, superannuation funds, residents and non-residents, with a multitude of different tax profiles.

In this way, the various forms of CGT relief available for corporate reorganisations are more directly relevant to a superannuation fund than to a MIT or similar transparent entity.

Secondly, the temporary CGT relief in Division 310 for superannuation fund mergers provides a template for the provision of permanent relief for these mergers. It resulted from extensive consultation with the industry, and includes all of the necessary integrity rules. In contrast, any proposal for CGT relief for the merger of MITs would require extensive consultation with all industry participants. Similarly, given the various tax profiles of the underlying unit holders in MITs, it would be necessary to ensure that the design of any relief took proper account of these varying tax profiles.

****

Should you have any questions on any of the matters raised in this submission please contact Fiona Galbraith, Director Policy on 03 9225 – 4021, 0431 490 240 or via fgalbraith@superannuation.asn.au.

Yours sincerely

Fiona Galbraith
Director Policy