File Name: 2017/12

10 May 2017

Jason Lucchese
Assistant Commissioner
Australian Taxation Office

via e-mail to: Jason.Lucchese@ato.gov.au

Dear Mr Lucchese,

Submission for exercise of the Commissioner's Remedial Powers
Superannuation: Transitional Capital Gains Tax (CGT) relief for unsegregated superannuation funds

The Association of Superannuation Funds of Australia (ASFA) would like to make a submission for the exercise of the Commissioner's remedial powers with respect to superannuation funds and the transitional Capital Gains Tax (CGT) relief available to unsegregated funds under sections 294-115 and 294 – 120 of the *Income Tax (Transitional Provisions) Act 1997.*

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 Australian 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.

We have been attempting to make a submission via the ATO's on line form since Monday 8 May, however, there appears to be a technical issue which precludes us from doing so and repeated 'phone calls to the ATO have been unable to provide a solution.

Accordingly, annexed is a copy of the information which would have formed the basis of the on-line submission.

We would welcome the opportunity to discuss with the ATO the matters raised in this submission, if appropriate. Should you have any queries please do not hesitate to contact me on (03) 9225 4021 or 0431 490 240 or via fgalbraith@superannuation.asn.au.

Yours sincerely

Fiona Galbraith
Director, Policy

ANNEXURE

Commissioner's Remedial Power

Please use this form to submit potential candidates for resolution using the Commissioner's remedial power. The remedial power is subject to certain limitations on its use. The information you provide through this form will help to assess whether the remedial power can be used to resolve the issue you have identified.

A. What is the issue?

Clearly articulate the issue. Describe the impact of the issue on the community. Short examples may assist.

As part of the Government's superannuation reform package which takes effect from 1 July 2017, transitional rules have been introduced to provide Capital Gains Tax ("CGT") relief in order to preserve the current tax exempt status of gains which have accrued but not been realised by superannuation funds prior to 1 July 2017. However, the design of the CGT relief in the context of unsegregated large funds - in particular large, APRA regulated funds - presents significant practical challenges.

These practical challenges will mean that superannuation funds may not be able to utilise fully the relief as intended and may incur considerable expense and risk in developing and implementing an interim solution that complies with the legislation. This potential loss of tax benefit and the significant, additional, cost involved in complying with the legislative method generally will be borne by the members of affected superannuation funds.

We submit that the cost of complying with the provision is disproportionate to achieving the intended purpose, especially having regard to the fact that this is a transitional measure.

Furthermore it is noted that the legislation for the CGT relief does not extend to Pooled Superannuation Trusts ("PSTs"), and this would appear to be an unintended omission. ASFA believes that

- the legislation should be amended to correct for this apparent unintended omission – by referring to the existing defined term of 'superannuation entity' as opposed to 'superannuation fund'; and
- that any proposed exercise of the Commissioner's remedial powers to provide a workable administrative solution for unsegregated superannuation funds should be extended to superannuation fund assets held via unsegregated PSTs.

B. Background

Provide relevant background information relating to how the issue has risen and a broad outline of the relevant legislative provision(s) the issue relates to.

The tax reform package introduces key changes affecting the potential value of a superannuation fund's member balances which will be in "retirement phase" from 1 July 2017. Specifically, the new $1.6 million Transfer Balance Cap ("TBC") under Division 294 of the *Income Tax Assessment Act 1997*, along with the deeming of Transition to Retirement Income Streams ("TRIS") as not being in the "retirement phase" pursuant to subsection 307-80(3) will, all things being equal, reduce a large unsegregated superannuation fund's Exempt Current Pension Income ("ECPI") proportion as determined in accordance with section 295-390.

In recognition of this, transitional CGT relief is available, the broad purpose of which is well articulated in paragraph 3.322 of the Explanatory Memorandum to the amending bill as follows:

> "*The object of the provisions is to provide relief for complying superannuation funds from the tax consequences for capital gains accumulated before 1 July 2017, where these gains would have been exempt income if realised prior to a commutation being made to comply with the transfer balance cap or the change to the treatment of TRIS*."

Similar remarks are made by the ATO in paragraph 9 of *Law Companion Guideline* LCG 2016/8.

Whilst there are some common concepts and key dates for the CGT transitional relief applicable to all complying superannuation funds, there are separate mechanisms and options for segregated superannuation funds (section 294-110 of the *Income Tax (Transitional Provisions) Act 1997*) as compared to unsegregated funds (sections 294-115 and 294-120).

Specifically, an unsegregated fund can choose to treat any or all qualifying CGT assets (based on them being held throughout the "pre-commencement period") as having been sold and re-purchased immediately before 1 July 2017 for consideration equal to the asset's market value. Any capital gain made (after reduction for any CGT discount entitlement and, critically, the fund's 2017 year ECPI proportion) is able to be deferred until a later realisation event happens to that asset (such as an actual disposal by the fund). At that point the deferred gain amount is crystallised and needs to be factored into the fund's overall net capital gain (or loss) position for that year of income.

Whilst the theory behind the transitional CGT relief is logical, the assessment undertaken by many large unsegregated superannuation funds and their custodians since the legislation was finalised (and even earlier when the exposure draft version was released for consultation) is that there are significant practical challenges that may prevent them from accessing the relief.

The single biggest impediment is that at least some of the custodians of superannuation funds (on whom funds rely for their broader CGT reporting) have indicated that significant upgrades may be necessary to their tax reporting and underlying IT systems to accommodate the relief. The main challenges here are:

- The need to undertake an analysis of all CGT assets at a parcel level, to identify which assets are eligible for the relief (i.e. held throughout the pre-commencement period), and then also to determine for which assets the relief should be chosen. This is not a straightforward exercise due to the differing unrealised CGT profiles, comprising assets in long gain, short gain and loss positions.
- The need to tag specific deferred gain amounts to assets on a parcel-by-parcel basis, such that when they ultimately are disposed of, the deferred gain is properly brought to account for tax purposes (along with the subsequent actual capital gain or loss based on the reset cost base).

Other implementation challenges include whether a custodian is able to isolate the deemed sale and reacquisition in terms of it only giving rise to the intended CGT consequences, without other flow on effects (such as triggering 45 day holding period rule testing). Some custodians advise that they may be able to do this, (albeit with potentially significant administrative effort at or around 1 July 2017 and then again on an ongoing basis to report on the subsequent disposals of the assets on which the relief is applied), whereas others have advised that they are unable to provide a systematic solution. In addition there are likely to be timing difficulties in how the CGT cost base adjustments for tax deferred distribution amounts are processed, along with how the ECPI reduction to the deferred gain is determined, as the relevant information will not become available until sometime after 30 June 2017.

For those superannuation funds using custodians that are unable to provide a systematic solution, many are understandably reluctant to create some form of manual work-around solution due to the vast scale of data involved, along with the significant complexity and risk this would entail. At the same time, these funds would not welcome any on-charge by custodians of significant one-off costs to develop this functionality (assuming it to be feasible within the short timeframe). Funds using custodians with a systematic solution would have similar reservations if this solution were to come at any significant cost.

Where a large unsegregated superannuation fund is unable to apply the transitional CGT relief, then to the extent that it has unrealised net capital gains, and that its ECPI proportion will decrease directly from 1 July 2017 as a result of the aforementioned changes (the common, if not universal, scenario), that reduced proportion of its unrealised gains shall become *prima facie* taxable at that point, notwithstanding that it would have been exempt if the underlying assets had been disposed of previously.

Dealing with this one-off additional tax liability (which initially, on 1 July 2017, would reside wholly within its "deferred tax liability" balance) will be a question for funds to address in the lead up to, and immediately after, 1 July 2017 and will raise significant equity and other considerations. If this is not allocated to member balances (e.g. via unit pricing or crediting rate adjustments) then it will likely affect funds' reserves.

C. How is the issue currently being managed?

Describe how the issue is currently being managed, including any administrative solutions that have been developed, such as practical compliance guidelines or ATO rulings. Has any guidance been provided for this issue?

There are currently no administrative solutions to deal with the above issue as it is a result of legislative changes that are not effective until 1 July 2017. The ATO has recently released *Practical Compliance Guideline* PCG 2017/3 outlining the ATO's compliance approach for segregated funds facing practical difficulties in complying with the changes to the taxation of transition to retirement income streams. Whilst the issues addressed by the ATO in that PCG are different to the one being raised here, it is submitted that the ATO should seek to provide, within appropriate boundaries, necessary support and guidance to all funds in dealing with the practical challenges that the superannuation reform package is presenting to funds that are facilitating its implementation.

D. What is the modification that should be made?

Outline the modification proposed to the particular provision(s), and how the modification would resolve the issue.

The modification that we suggest would take the form of an alternative approach to determining the amount of CGT relief as outlined below. This has been separated to address the different effects on ECPI from pension account balances being reduced prior to 1 July 2017 due to the $1.6 million TBC, and due to TRIS members who are not considered to be in retirement phase, for reasons as discussed.

Impact of $1.6 million TBC

It is expected that members who currently have pension account balances in excess of the $1.6 million TBC will actively commute amounts prior to 1 July 2017. In respect of those members, the reduction in a large unsegregated fund's ECPI is a permanent adjustment.

Funds will not necessarily know all of their members who are at risk of breaching the $1.6 million TBC (e.g. due to members whose pension account is below the TBC but who have other superannuation income stream accounts elsewhere). Nevertheless the fund will have documentation supporting the full or partial commutation of members' accounts from pension phase back to accumulation phase during the pre-commencement period and it would be reasonable to assume that this will have been done only because of the new TBC.

The amounts commuted will be able to be measured as a percentage of the fund's total FUM as at 1 July 2017, which effectively represents the reduction in the ECPI attributable solely to the $1.6 million TBC.

The modification suggested in this regard is for that percentage to be applied to the fund's net unrealised CGT gain position determined just before 1 July 2017, to identify the value of the unrealised net capital gain accrued at that date in respect of pension members' balances above the $1.6 million TBC. As this accrued gain would not be taxable if the assets were actually disposed of on 30 June 2017, it should be converted into a one-off "reduction in capital gain" amount.

This one-off reduction in capital gain should then be available in later years to apply against capital gains made as the assets held by the fund as at 30 June 2017 are disposed.

Rather than tracking the fund's actual disposals on an asset-by-asset basis, which would bring with it significant practical difficulties as mentioned above (similar to the current CGT transitional relief for unsegregated funds), a simpler method to bring this one-off reduction in capital gain amount to account could be either:

i) On a straight line basis over a set period which broadly reflects the number of years over which funds might be expected to realise their investments (perhaps somewhere between 5 years and 10 years); or

ii) On a pro-rata basis where the amount able to be claimed in a future year is a fraction of the one-off reduction in capital gain, where the numerator is the net realised capital gain for that year (ignoring the CGT discount) and the denominator is the net unrealised capital gain as at 30 June 2017 (again, ignoring the CGT discount).

Given that for many large unsegregated funds the impact of the $1.6 million TBC on their ECPI is not expected to be substantial, method i) from above is preferred on the grounds of simplicity. There is also recent legislative precedent to apply a straight line approach to transitional balancing adjustments such as upon the introduction of the Taxation of Financial Arrangements rules from 1 July 2010.

One significant benefit of this modification is that the information required by funds to implement it should readily be available. In particular, funds already determine their 30 June year end unrealised net capital gain position for financial statements and unit pricing tax accrual purposes, by reference to CGT cost base records and market valuations. It is submitted that this information can be leveraged with minimal risk of manipulation or abuse by funds in terms of the accuracy of the information used.

Impact of TRIS changes

Whereas the impact of the $1.6 million TBC on a fund's ECPI from 1 July 2017 is considered to be permanent, it is acknowledged that the TRIS members who lose tax exempt status on their superannuation account earnings will most likely return to the retirement phase after they meet other conditions of release. How quickly this occurs will be different from fund to fund based on many factors.

In light of the above, the impact of the "day 1" ECPI adjustment which occurs on 1 July 2017, when a number of TRIS members will lose their tax exempt status, is only actually borne by funds as a permanent cost to the extent that the fund disposes of assets prior to those members entering into the retirement phase.

As at 1 July 2017, the youngest TRIS members will be 56 years and 1 day old, and so all TRIS members will attain the age of 65 years no later than 30 June 2026 that is the latest date that they will meet a specified condition of release. Whilst 9 years is the maximum period before a TRIS member would be expected to enter into retirement phase, for other TRIS members who are older this period might be significantly less.

Again, there would be significant practical challenges if an unsegregated superannuation fund had to track this on an individual TRIS member basis, and therefore the suggested modification is as follows:

i) A fund will need to determine the average age of its pre retirement phase TRIS members as at 30 June 2017 which is rounded down to a whole number of years;
ii) This number is then subtracted from 65, being the latest age when pre retirement phase TRIS members will meet a specified condition of release;
iii) The number will therefore be between 1 and 9 for all funds subject to the age profile of their pre-retirement phase TRIS members;
iv) A fund will need to obtain actuarial certification as at 30 June 2017 (or 1 July 2017) which specifically identifies the "day 1" impact on the fund's ECPI of pre retirement phase TRIS accounts losing tax exempt status;
v) That impact is then assumed to reduce over the number of years determined under ii) above, on a straight line basis, with averaging of the opening and closing positions to say two decimal places; and
vi) For those years, a specific percentage of the fund's net realised gain should be exempt (the "reduction factor"), over and above the fund's actual ECPI adjustment for that year.

As an alternative to points i) to iii) above, as part of the modification the ATO could specify a default average age for TRIS members on 1 July 2017, and therefore the number of years for which the CGT adjustment can be made. ASFA would be pleased to provide information to the ATO to assist in this. Funds would then have the option to calculate their own average or to apply the ATO default.

By way of example, say a fund's ECPI percentage declines from 10% to 8% because of the TRIS changes from 1 July 2017, and the average age of its pre retirement phase TRIS members on this date is 60.5 years. The above approach would enable that fund to determine an exempt amount of realised net capital gains for 5 years i.e. for the years ending 30 June 2018 to 30 June 2022. Applying a straight line reduction factor approach, the precise exempt percentage of the fund's net capital gain for each year would be as follows:

Income year ending	Opening Proportion	Closing Proportion	Reduction Factor
30 June 2018	2.00%	1.60%	1.80%
30 June 2019	1.60%	1.20%	1.40%
30 June 2020	1.20%	0.80%	1.00%
30 June 2021	0.80%	0.40%	0.60%
30 June 2022	0.40%	0.00%	0.20%
30 June 2023	0.00%	N/A	N/A

Again, it is noted that the information required by funds to implement the above modification should be available or able to be determined readily from available information. In particular, in respect of iv) above, it is submitted that actuaries would already need to consider this impact to determine the appropriate weighted average ECPI proportion applicable to the fund for the year ending 30 June 2017.

E. How is the proposed modification not inconsistent with the intended purpose or object of the provision?

The intended purpose or object of the provision might be shown in certain documents, such as the explanatory memorandum, second reading speech, relevant committee reports, and other contemporary documents that accompanied the original introduction or subsequent amendments to the relevant provision.

Consideration may also be given to other material such as the legislative provisions themselves or relevant Government announcements. Unlike statutory interpretation approaches, primacy is not to be given to the text of the relevant provision when ascertaining the intended purpose or object of a provision for the purpose of using the remedial power.

As described above, based on the object of the transitional relief being to *"…provide relief for complying superannuation funds from the tax consequences for (the exempt proportion of) capital gains accumulated before 1 July 2017…."*, the proposed modification is consistent with this stated purpose and has been submitted to achieve this purpose in an effective and cost efficient manner. We submit that the cost of complying with the provision is disproportionate to achieving the intended purpose, especially having regard to the fact that this is a transitional measure.

F. How is the proposed modification reasonable?

Describe how the suggested modification would be considered reasonable.

Modifications made using the remedial power must be reasonable, having regard to the intended purpose or object of the provision to be modified and whether the cost of complying with that provision is disproportionate to achieving that intended purpose or object.

Other matters which go to reasonableness include:

•the extent to which the modification is favourable to entities;

•whether the modification would result in any adverse impacts on the tax liability of a third party or asymmetrical tax outcome;

•any current judicial interpretation of the relevant law;

•whether the modification would address a discrete or systemic issue with the law; and

•whether there are any differing stakeholder views on the issue.

It is submitted that the proposed modifications are reasonable, for the key reasons that:

- They are simple for funds and their custodians to implement, and do not require any custodian system upgrades, which have the potential to add unnecessary costs, risks and inefficiency to the superannuation system that are ultimately borne by members, for what is transitional relief. This is especially the case for those funds that use custodians that have indicated that they are unable to provide a systematic response to enable funds to utilise the relief; and
- They will better address the one-off "net" tax liability which is created in the fund on 1 July 2017 and which needs to be adjusted either against member balances or reserve accounts. This is because the increased deferred tax liability would be better matched and offset by the current / deferred tax asset for the one-off reduction in capital gain, thus avoiding member equity and other issues.

Various stakeholders in the superannuation industry have raised similar practical concerns with the current CGT transitional relief. This includes Ernst & Young; KPMG; PWC, Deloitte and a number of large industry funds who have collaborated to develop the proposed modifications. Accordingly, we are confident that these proposed modifications would be seen as being reasonable.

G. What might the budget impact of the proposed modification be?

The assessment of budget impacts will be determined by the Treasury or department of Finance. Please include any information that would assist in preparing an assessment of budget impacts of the modification. For example, a description of the population of entities affected, or whether the change would provide greater access to a tax benefit such as a deduction, offset or tax exemption.

On the basis that the proposed modifications provide a reasonable basis for achieving the stated purpose of ensuring the preservation of the tax exempt status of the (pre-superannuation reform) ECPI proportion of unrealised capital gains positions immediately prior to 1 July 2017, then it is submitted that the proposed modification is revenue neutral.

It is only by reference to the prospect of large unsegregated funds not being able to apply the current version of the CGT transitional relief that budget impacts might be seen to arise (in which scenario those funds would pay additional tax reflecting increased capital gains that had accrued in pension phase prior to 1 July 2017). This, however, could not reasonably be considered to be an appropriate basis for comparison.

H. Have all other avenues been explored to address this issue?

Provide an outline of the other options that have been considered, including changes in administrative practices or issuing new public guidance material.

Similar proposals to the above were raised by various parties with Treasury during late 2016 during the consultation process on the amending bill. Whilst no specific response was provided as to why the CGT transitional relief mechanism was not changed in any meaningful way, we are conscious that Treasury was working within extremely tight timeframes to finalise the legislative package that was complex, lengthy and addressed a number of separate measures. We submit that, given there was not sufficient time to properly assess and address all of the practical consequences from the many changes within the superannuation reform package, this is a measure – especially as it relates to transitional relief – which may lend itself to being subject to an exercise of the Commissioner's remedial power. Indeed, we would submit that, using the ATO words as to when this power may be applicable, this is a classic example of where "…the current law is producing unintended, negative impacts for taxpayers or is creating excessive compliance costs".

I. Additional Information

Provide any additional information that may assist.

J. Contact Details

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