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: 1300 926 484
w: www.superannuation.asn.au

File Name: 2013/38

6 September 2013

Mladen Bajic
Australian Taxation Office
GPO box 9977
Sydney NSW 2001

Email: mladen.bajic@ato.gov.au

Dear Mladen,

DRAFT TAXATION DETERMINATION TD 2013/D7

The Association of Superannuation Funds of Australia (ASFA) wishes to provide the comments below in relation to the draft Taxation Determination TD2013/D7 which poses an answer to the following question:

> Income tax: in what circumstances is an asset of a complying superannuation fund a segregated current pension asset under section 295-385 of the income Tax Assessment Act 1997?

ABOUT ASFA

ASFA is a non-profit, non-political national organisation whose mission is to protect, promote and advance the interests of Australia's superannuation funds, their trustees and their members. We focus on the issues that affect the entire superannuation industry. Our membership, which includes corporate, public sector, industry and retail superannuation funds, plus self-managed superannuation funds (SMSFs) and small APRA funds through its service provider membership, represent over 90% of the 12 million Australians with superannuation.

GENERAL COMMENTS

The draft Determination ("draft TD") appears to have been written primarily with its applicability to an SMSF in mind. This is evidenced by all of the examples using funds with one or two members only.

Segregation, and what is necessary to constitute effective segregation, is a growing subject of interest to the large APRA regulated superannuation funds and their advisers. Due to the increasing complexity of arrangements within the superannuation industry ASFA welcomes the intention of the ATO to bring some clarity to the operation of the law in this area.

ASFA considers that if the ATO is proposing to issue a tax determination on this topic then it is critical that the determination also considers the subject matter from the perspective of large APRA regulated funds, and the variety of arrangements such funds may have for the allocation of earnings (and the potential disconnection between these arrangements and the fund's actual investments for different sub-groups of members).

We note the absence in the draft TD of any specific reference to defined benefit funds. This omission potentially limits the applicability of the ruling and as such, does not provide complete certainty of the application of the law (to the extent that certainty is ever possible).

Separately, the importance of the subject matter gives rise to the question of whether this should in fact be the subject of a Taxation Ruling rather than a Determination.

> **Recommendation**
> ASFA recommends that consideration be given to releasing the subject matter as a Taxation Ruling.
>
> ASFA further recommends that an additional round of consultation be undertaken prior to finalisation.

SPECIFIC COMMENTS

Paragraphs 1 and 2 - Only whole assets can be segregated

A key theme of the draft TD is that only whole assets can be segregated (although a close analysis of the draft TD itself indicates the prohibition on segregating partial assets may be restricted to cases where the balance of the asset is used for a non-pension purpose).

ASFA is concerned at the lack of recognition that a fund may own only a part of an asset. For example, a fund may own 463.52 units in a unit trust or 463.52 shares. It is common practice for unit trusts to issue interests in partial units and it is not uncommon, at least in other markets, for partial shares to be made available.

Failure to recognise such practices in the draft TD will cause confusion as well as difficulties for many funds using the provisions of Section 295-385(4). For example, in a fund where the only liabilities are prescribed pensions, fractions of units held in unit trusts and fractions of shares will need to be separately accounted for and will be subject to tax unless the trustee obtains an actuarial certificate under section 295-390 (using the 'unsegregated assets' or 'proportional' method). This clearly would not have been the intention of the legislators who inserted the predecessor clause to Section 295-385(4) and – as noted in the draft TD itself – it is to be assumed that the rewrite of former section 273A(2) into section 295-285(4) was not intended to change its previously understood meaning.

> **Recommendation**
> ASFA recommends that the draft TD be amended to indicate it is possible to segregate partial assets where the balance of the partial asset is not owned by the fund or where the part-asset is capable of being transferred or of being redeemed for cash.

Paragraphs 2, 56 to 58 and footnote 4: A bank account, being a single chose in action at law

Paragraph 2 states that a bank account is a 'single chose in action' and, in effect, precludes a fund from applying an accounting methodology to notionally divide the account into sub accounts for the purpose of classifying part as a segregated current pension asset and part as a non-pension asset.

While the term 'chose in action' is used several times, the draft TD does not define it but instead assumes that the term will be understood by the reader.

A 'chose in action' is a technical legal term relating to personal rights to property which can only be claimed or enforced by an action and not by taking physical possession of the property. As such it is contrasted to a 'chose in possession' which is a right of which the owner has the actual enjoyment. Complicating the issue are such technical legal matters as the right to withdraw monies from a bank account and that the actual cash is considered a fungible and not an asset per say.

We suspect the term 'chose in action', and particularly its relevance to a bank account, would not be well understood by the vast majority of readers.

Recommendation

ASFA recommends that either the term 'chose in action' be replaced by common English or alternatively the draft TD properly defines the term and explains its application to a bank account.

Paragraphs 56 to 58 sets out the reasons for the draft TD's classification of a bank account as a single chose in action. The argument put forward is at odds with other statements by the ATO as to how bank accounts may be dealt with. For example, many fund custodians operate omnibus bank accounts – a single bank account with sub accounts for particular portfolios, fund managers and sometimes members. For forex purposes, the ATO has required the lodgement of separate functional currency elections with respect to the individual sub accounts. This draft TD's position that it is not possible to segregate part of a bank account (for example, a sub account or sub accounts that operate separately for pension members) is at odds with the forex direction that requires each sub account to be treated separately.

The statement also appears to be at odds with the statement in Example 5 with respect to segregation of particular assets. At paragraph 31 it states that, with respect to uncertificated shares, and units in a listed property trust, the shares and units 'can be held as segregated current pension assets, provided appropriate evidence is kept to demonstrate which shares and units are segregated. Paragraphs 61 and 62 of the draft TD provide further evidence of how this is to be achieved. ASFA would argue that the ATO should similarly accept an accounting approach with respect to a single bank account where sub accounts are contemporaneously maintained that separately recognise those parts of the bank account that are held and operated on behalf of pensioners and non-pensioners.

At a practical level, for large funds, a conclusion that an omnibus bank account with sub-accounts cannot choose to segregate one or more of these sub-accounts would make the process of segregation significantly more expensive.

For example, some large funds now offer "member direct" options, where members can choose to invest their super in direct shares, term deposits, etc. A common approach for these arrangements is to require a minimum amount to be held in cash, to enable future share purchases, and also to receive dividends, interest, etc. This is generally done by using an omnibus bank account, with sub-accounts for each individual member. If the same omnibus bank account had sub-accounts for both pension and accumulation members, this would seem not to satisfy segregation based on the draft TD. If two omnibus bank accounts were operated, one for pension members and one for accumulation members, this would seem to significantly increase administrative complexity (and thus costs) in shifting members from accumulation phase to pension phase.

Even for those funds not offering "member direct", but segregating by having two separate investment mandates with each of its investment managers, the separate bank account issue may prove problematic and costly. As stated above in relation to the forex issue, a fund's custodian will typically use a single omnibus bank account, with sub-accounts for each investment manager (with two sub-accounts for each manager with separate pension and accumulation mandates), all identified by separate accounting and record keeping codes. Banking arrangements within a custodian would be much more complex and costly, if the custodian was to be required to have separate bank accounts for each manager, and then separate bank accounts for accumulation and pension mandates with the same manager. This alone could render segregation very difficult to achive for larger funds, even though many (as scale increases) are considering moving to a segregated model to address the equity issues that frequently arise in using the non-segregated asset method.

As stated at the beginning of this submission, the comments in the draft TD may be reasonably straightforward and workable for an SMSF, but appear to demonstrate a misunderstanding of the banking arrangements for large superannuation funds and the associated accounting practices.

We note that Example 3 allows for transfers between bank accounts within a reasonable time and gives 28 days as an example. This type of approach, whilst easily adopted by an SMSFs, is unlikely to be practical solution for large funds and is a considerably less rigorous approach that that achieved through the operation of sub-accounts.

With reference to the examples of particular expenses that may be paid from a particular account even though it relates to both accumulation and pension members, ASFA notes that the only example cited is the annual supervisory levy. Further guidance as to what other expenses are consider to be essential and incidental or necessary for this purpose would be appreciated.

> **Recommendation**
> ASFA recommends that the position regarding bank accounts be reviewed so as to provide consistency with both the forex requirement and the treatment of uncertified shares as set out in paragraph's 56 to 58 of the draft TD so at to permit existing industry practices to continue unhindered.
>
> ASFA recommends that further guidance be provided as to what other expenses may be considered to be essential and incidental or necessary for the purpose of paragraph 7 and Example 4.

Paragraph 3
As stated earlier, ASFA is concerned that the draft TD appears to be based on the operation of an SMSF and does not reflect the operations of a large APRA regulated fund or a defined benefit fund.

Paragraph 3 of the draft TD states that:

> *"Whether an asset is invested, held in reserve or otherwise being dealt with for the relevant sole purpose of enabling a fund to discharge liabilities in respect of superannuation income stream benefits is an objective question determined by examining all the facts and circumstances, particularly the allocation, application or distribution of the income from the asset (our emphasis). The purpose will be evidenced by records of the trustee, such as resolutions, accounting records, financial statements, investment strategies or policies, actuarial reports or certificates, bank account statements and share holding statements."*

The draft TD provides no legislative or other support for this proposition.

In a larger, APRA regulated, fund, there can be significant disconnection between the members' selected investment options, the assets actually held by a fund, and the allocation, application or distribution of earnings (from various assets) to the members. For such funds, segregation may often be used solely in relation to the preparation of the fund's income tax return. As such it may have little real life outside this frame, apart from regular monitoring by the actuary to ensure the segregated assets remain no greater than the fund's pension liabilities.

By way of explanation, the following example sets out a method of operation for a defined benefit fund:

> **Example 1**
> A defined benefit fund has pension members equal to 20% of its total liabilities at a particular date. It chooses to treat a group of its assets, equalling 20% of its total assets, as segregated pension assets, and obtains the necessary actuarial certificate to the effect that the selected assets and the earnings expected from them will provide the fund with the amount required to discharge

its pension liabilities. This certificate is updated annually to ensure that the group of selected assets remains at a level appropriate to the discharge of these pension liabilities (with potentially additional assets added or removed from the segregated pool of assets if required by the actuary). The fund's tax return is prepared on the basis that all income from the segregated group of assets is exempt, all expenses relating to this group of assets is non-deductible, any foreign income taxes paid in respect of this group of assets is non-claimable as foreign income tax offsets, and all capital gains and losses accruing on this group of assets are disregarded in the fund's overall calculation of its net capital gain or loss.

Given that the fund is a defined benefit fund, there would be no connection between the earnings on the selected assets and the pension members' accounts, and indeed it would be possible for some of the earnings to accrue to the broader non-pension defined benefit members, or even to accumulation members within the same fund (if the defined benefit section reached a sufficiently healthy level of funding that moneys were allocated from it to enhance earnings to the accumulation membership).

If there needs to be a connection between segregated assets and member accounts in the manner described in paragraph 3, this would seem, if taken to its logical conclusion, to mean that the segregation method in section 295-385 is unavailable to all defined benefit funds. As noted above, the draft TD is basically silent on how segregation is intended to apply for defined benefit funds.

Should the ATO view be that a defined benefit fund cannot use the segregation method, but must use the non-segregated pension assets method in section 295-390 only, the draft TD should be amended to reflect this. Noting the possibility that some defined benefit funds may currently be using the segregation pension assets method, the application date for the finalised TD should be set sufficiently in the future to provide these funds with sufficient time to change to the non-segregated assets method and obtain the necessary actuarial certificates.

Although such a view would **not** be the view of the industry, such a decision would at least give the industry certainty of the ATO view and lead to consistency of application.

In contrast, if the ATO view is that defined benefit funds **are** able to use the segregation method, the draft TD needs to provide clear reasons as to why this is so, given that such funds cannot generally show any connection between the pension members, the segregated assets, and the allocation, application or distribution of the income from these assets.

Recommendation
ASFA recommends that the draft TD specifically address the question of whether a defined benefit plan is able to use the segregated pension assets method.

Following on from the above example, the following is an example of one method by which an APRA regulated fund may apply the segregated pension assets method:

Example 2
Assume that a fund has 90% of its members in its default option, but 10% in a range of other investment options, including the 5% of the fund membership who are pensioners. Assume further that the fund weighs up the rebalancing and transaction costs that would be involved in precisely aligning a fund's investments with the members' selected investment options and decides to actually have only one investment strategy (being that which supports its default option). In this instance the fund decides to allocate earnings to the non-default members in line with their selections through shadow calculations based on the earnings that would have accrued if the fund had invested in each member's selections. In effect, the fund's reserves, or its default option members, bear the costs or obtain the benefits if the earnings allocated to the non-default options

are, in total, greater or less than the non-default members' share of earnings in the default option. [Note – at least in pre-MySuper days, this was a not uncommon approach to providing a range of investment options in some smaller funds, and is likely to continue to be prevalent in these funds to the extent that the MySuper rules allow.]

If the fund decided to choose a group of its assets equal to 5% of its total assets, and treat them as segregated for tax return purposes (supported by an actuary's certificate that this group of assets and anticipated earnings was sufficient to meet these pension liabilities, and with regular actuarial reviews requiring movements of assets into or out of the segregated pool if the value fell out of alignment with the pension liabilities), this would arguably satisfy all legislative requirements for segregation.

ASFA considers that there is nothing in the legislative framework that would require that none of the earnings on the segregated assets may accrue, from a member accounting perspective only, to non-pension members. To require such a connection would be illogical in the circumstances set out in this example, as the entire structure of the fund provides earnings to members in the non-default versions for both accumulation and pension options that do not necessarily reflect the actual earnings of the fund.

Should the ATO view be that funds in these circumstances cannot segregate, and are therefore limited only to using the non-segregated method in section 295-390, then the draft TD should be amended to reflect this and provide clear reasons as to why this is so.

Although such a view may **not** be shared by parts of the industry, such a decision would at least give the industry certainty of the ATO view and lead to consistency of application.

Recommendation
ASFA recommends that the draft TD specifically address the above example and provide clear reasoning for the position adopted.

A final example on this topic deals with investments in pooled superannuation trusts (PSTs) in circumstances where the PST is unable to determine the extent to which its units are held by its unit holders on behalf of their pension versus non-pension members.

Example 3
Assume that a fund intends to primarily use the non-segregated asset method, but holds 10% of its assets in PSTs, and those PSTs provide no mechanism whereby unit holders can specify which of their units are held for pension members and which for accumulation members. Thus, the PST has no way of claiming the pension exemption itself, and pays the full 15% on all of its earnings.

Assume that the fund's pension percentage is 20% of its total assets, or 22.22% (i.e. 20/90) of its non-PST assets, and that its total investment income is $985,000, earned $900,000 in a pre-tax form from its non-PST assets and $85,000 in an after-tax form from its PST assets.

Prima facie, the fund's exemption under section 295-390 would be 20% of $900,000 only (i.e. $180,000) and it would in effect have obtained no benefit from the pension exemption in relation to the income received through its PST assets.

However, the fund could choose to segregate the PST assets as "non-pension assets". If it did so, the fund's exemption under section 295-390 would then be 22.22% of $900,000, or $200,000. The extra $3000 tax saving (i.e. $20,000 x 15%) is equivalent to that if the PST had treated 20% of its income relating to the fund as exempt.

In these circumstances, the fund has only chosen to segregate the PST investments as "non-pension assets" so that its members are not otherwise deprived of some of the benefits of the tax exemption that would have been available if the earnings in the PST had been derived pre-tax. Given that this was the

reason for the fund's choice to segregate the PST investments, and given the enhanced equity outcomes to members that then resulted, there would appear to be no logical reason why the fund could not, in its member accounting, still choose to allocate some of the earnings from the PST investments to its pension members (i.e. no logical reason why it could not choose to limit the application of segregation to its tax return and actuarial certificate arrangements).

If it is the ATO view that a fund in these circumstances cannot segregate PSTs as "non-pension" assets, with the consequential inequitable outcomes to members from using the non-segregated pension assets method, then the draft TD should state this.

Although such a view would **not** be the view of the industry, such a decision would at least give the industry certainty of the ATO view and lead to consistency of application.

> **Recommendation**
> ASFA recommends that the draft TD specifically address the above example and provide clear reasoning for the position adopted.

Paragraph 9
This paragraph deals with the situation where a superannuation fund only has members in receipt of pension. It concludes with the statement that for such a fund the apportionment approach under section 295-300 (the unsegregated asset approach) cannot be adopted. As this statement is not supported by any arguments it remains unclear why the ATO considers the unsegregated approach cannot be used. Despite the lack of argument, this paragraph seems to conflict with other sections of the draft TD or the Act itself:

- The statement that a part of an asset cannot be segregated. If the fund's assets include 2304.62 units in unit trust A and 463.52 units in unit trust B, what happens to the partial units (0.62 units in A and 0.52 units in B)?
- Paragraph 10 which threatens action under Part IVA if assets are sold shortly after being segregated; and
- Section 295-385(5) of the Act (where a non-prescribed pension ceases during the year – the approach in 295-385(4) cannot be applied for the whole year).

Further, there are many cases in which the position described in Paragraph 9 is reached during the year such as:

- The first year in which all fund members commence receiving prescribed pension.
- When the last non-pensioner moves to pension phase.
- Where a pensioner dies and the death benefit is not paid in a timely manner in accordance with the recently amended legislation.

In such circumstances it may be necessary for the fund to apply the unsegregated approach, at least for that portion of the year when all members were not receiving prescribed pensions.

> **Recommendation**
> ASFA recommends that this paragraph be amended to as a minimum, be expanded to cover the issues raised.

Paragraph 10

This paragraph raises the possibility that where an asset is disposed of shortly after being segregated and a capital gain is realised, the anti-avoidance provisions of Part IVA of the ITAA 1936 may be applied to treat the gain as assessable income.

In and of itself, this paragraph appears merely to restate the long standing principles set out in the Explanatory Memorandum ("EM") that accompanied the introduction of former section 282B of the ITAA 1936, the predecessor section to section 295-385.

However, the statements in the EM were largely directed at strategies involving the transfer of assets into the segregated pool immediately before disposal, and there is wide acceptance within the industry that Part IVA may apply to such strategies.

In contrast, paragraph 10 would appear on its words to give rise to the potential application of Part IVA in a broader range of circumstances, including those where a member waits until he or she commences a pension to dispose of a particular asset. This is particularly so, when the words in paragraph 10 are combined with the conclusion in paragraph 9 that the segregation method may be the only method available to funds where all members have moved into pension phase. Thus, in the absence of examples of where Part IVA might and might not be applied, the re-statement of the principles from the EM does not assist the correct application of the law by the reader. ASFA is concerned at what appears to be an attempt by the ATO to influence the adoption of a behaviour that is not actually required by the law. For example, consider the situation of a single member SMSF where the member has just commenced an account based pension. The fund's assets include a property which has been held for many years. As the only member is now receiving a prescribed pension and the value of assets does not exceed the value of the pension, paragraph 9 indicates that all of the assets must be segregated (and the unsegregated approach cannot be used).

Shortly after commencing the pension, the property is sold. The sale may have arisen for a number of reasons including:

- The trustee considers it is not an appropriate long-term investment now that the member is in the pension phase; or
- The trustee has received a generous offer from a purchaser.

The draft TD throws doubt on the tax treatment for sales in these circumstances. ASFA poses the question: Would such a transaction be challenged by the ATO under Part IVA?

We note that under recent amendments to the SIS Act, section 52(2)(vi) now imposes a positive obligation on the trustee of an APRA regulated fund to consider the expected tax consequences for the fund in relation to the investments covered by its investment strategy. Under this obligation, the trustee of an APRA-regulated fund in the above scenario may have been considered to be in breach of its fiduciary responsibilities if it had sold the property just prior to the member commencing a pension, as this would potentially have resulted in an unnecessary capital gains tax liability. We note that the SIS Act does not directly impose a similar obligation on the trustee of an SMSF. However the absence of an express obligation should not be interpreted as saying that one does not exist. Rather, it reflects the difference in the relationship between trustee and member in an APRA regulated entity and an SMSF. In an SMSF, the member is in a position to ensure that the trustee considers the tax consequences for the fund and its members in relation to the investments covered by its investment strategy.

ASFA considers that the draft TD should apply an even handed application of Part IVA across all funds and that, for the draft TD to be of assistance, examples need to be provided that would assist trustees to understand the types of situations which it finds acceptable and the types it does not.

Recommendation

ASFA recommends that the draft TD be amended to reflect the obligation on trustees of both APRA and ATO regulated fund trustees to consider the expected tax consequences for the fund in relation to the investments covered by its investment strategy.

ASFA recommends that either the reference to the application of Part IVA be removed or the draft TD be expanded to include appropriate examples that would assist an understanding of the ATO view of acceptable practice."

Paragraphs 64 to 67

These paragraphs deal with the fundamental issue that segregated assets must be "invested, held in reserve or otherwise dealt with".

We are concerned with the wording used in these paragraphs and the potential wider implications.

The draft TD states that an asset will be 'invested' for that purpose where the asset is 'held to receive income to enable the fund to discharge superannuation income stream benefits'. However, it is clear that some investments do not produce income but are purchased in order to generate capital gains which will be used, once the asset is disposed of, to discharge superannuation income stream benefits. This could include gold bars, artwork as well as some financial products. In our view, notwithstanding that these investments do not produce income, they are still "invested" for the relevant purpose.

Similarly, we disagree with the interpretation of "held in reserve". We do not consider a property which is currently not receiving investment income to be held in reserve. It is at all times an investment of the fund. The connotation of 'reserve' can introduce other concerns such as the treatment of allocations from reserves etc.

Recommendation

ASFA recommends that the topic considered by paragraphs 64 to 67 be rethought with a view to providing a better form of wording.

* * * * *

If you have any queries or comments regarding the contents of our submission, please contact Robert Hodge on (02) 8079 0806 or via e-mail rhodge@superannuation.asn.au.

Yours sincerely

Fiona Galbraith
Director, Policy