File Name: 2017/11

26 April 2017

Manager
Retirement Benefits Unit
Retirement Income Policy Division
The Treasury
Langton Crescent
PARKES ACT 2600

via e-mail to: superannuation@treasury.gov.au

Dear Ms Johnson,

Re: Consultation on Exposure Draft *Treasury Laws Amendment (2017 Measures No. 2) Bill 2017: superannuation reform package amending provisions* and Explanatory Memorandum

The Association of Superannuation Funds of Australia (ASFA) would like to lodge this submission in response to the consultation on the exposure draft *Treasury Laws Amendment (2017 Measures No. 2) Bill 2017: superannuation reform package amending provisions* (Bill) and Explanatory Memorandum.

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.

A. General observation

ASFA welcomes the release for public consultation of the exposure draft of the Bill and Explanatory Memorandum. We welcome, and are generally supportive of, the minor and technical amendments being effected by the Bill. There are, however, some significant issues - with respect to the transitional CGT relief and the inability for funds to pay a taxed income stream - that are of concern to a number of our member trustees. We have also identified some technical issues with the Bill as drafted which have documented below.

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B. Issues

1. Transitional Capital Gains Tax (CGT) relief and pooled superannuation trusts/life companies

Subdivision 294-B of the *Income Tax (Transitional Provisions) Act 1997* (TPA 97) provides temporary relief for a complying superannuation fund from capital gains tax which otherwise would arise as a result of the policy changes which come into effect on 1 July. This would arise where, because of the Transfer Balance Cap, a member commutes an income stream and also arises as a result of the exclusion of 'transition to retirement' income streams from the zero tax rate.

Unfortunately, due to what appears to be a drafting error, the legislation refers to complying superannuation 'funds, as opposed to complying superannuation 'entity'. This has the effect only those funds, which are invested directly, are eligible for the benefit of the transitional CGT relief – funds invested through a Pooled Superannuation Trust (PST) or a life company effectively are excluded from the relief.

This will create the anomalous outcome where members whose fund invests through a PST/life company will be unfairly disadvantaged simply on the basis of their fund's investment structure. The relief should apply to all members of superannuation 'funds' irrespective of whether the assets are held directly or through a PST/life company.

In order to address this anomaly and ensure that the retirement savings of all members are treated equally we recommend that Government consider including amendments in the Bill when it is introduced to provide the transitional CGT relief to superannuation *entities*. Indeed, it is our understanding that the concept of superannuation entity originally was created to cater for similar circumstances.

2. Transitional CGT relief for unsegregated funds - administrative complexity

Transitional rules have been introduced to provide CGT relief, however, the design of the relief for large unsegregated funds presents significant practical challenges.

The new $1.6 million Transfer Balance Cap under Division 294, along with the change to the treatment of TRISs where the member has not satisfied a specified condition of release pursuant to section 307-80, will have the effect of reducing the Exempt Current Pension Income ('ECPI') proportion of large unsegregated superannuation funds' assets, as determined in accordance with section 295-390.

The broad purpose of the transitional CGT relief is articulated in paragraph 3.322 of the explanatory memorandum of 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.'*

Whilst there are some common concepts and key dates for the CGT transitional relief, which are applicable to all complying superannuation funds, there are separate mechanisms and options for segregated superannuation funds (section 294-110 of the TPA 97) as opposed to unsegregated funds (sections 294-115 and 294-120).

An unsegregated fund can choose to treat qualifying CGT assets as having been sold and re-purchased immediately prior to 1 July 2017 for the asset's market value, with any capital gain (after reduction for any CGT discount entitlement and – importantly - the fund's 2017 year ECPI proportion) able to be deferred until a later realisation event. Upon realisation the deferred gain is crystallised and 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 sound, the assessment undertaken by many large unsegregated superannuation funds and their custodians since the legislation was finalised (and earlier when the exposure draft was released for consultation) is that there are significant practical challenges that may prevent them from accessing this relief.

The single biggest impediment is that a number of the custodians providing services to superannuation funds, on which funds rely for their broader CGT reporting, have indicated that significant system upgrades to their tax reporting and underlying IT systems will be necessary to accommodate the relief. The main challenges include the need to:

- undertake an analysis of all CGT assets at a parcel level, to identify which assets are eligible for the relief and which of these assets should be chosen for the relief. This is not a straightforward exercise due to the differing unrealised CGT profiles, comprising assets in long gain, short gain and loss positions;
- tag specific deferred gain amounts to assets on a parcel-by-parcel basis, so that when they are disposed 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 such that it only gives rise to the intended CGT consequences (transitional CGT relief) without unintended consequences (such as triggering 45 day holding period rule testing)
- there are likely to be timing difficulties in how 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 cannot provide a systematic solution, due to the vast scale of data involved many are understandably reluctant to create a work-around solution which would create significant complexity and risk
- custodians would be likely to need to recover the significant one-off costs to develop the functionality, if it were feasible within the short timeframe.

Where a large unsegregated fund is unable to apply the transitional CGT relief then, to the extent it has unrealised net capital gains and its ECPI proportion has decreased as a result of 1 July 2017 changes, the reduced proportion of unrealised gains will become taxable at that point. This is notwithstanding the fact that it would have been exempt if the underlying assets had been disposed of previously.

We believe that one or more of the large accounting firms has liaised with Treasury about a possible alternative method for determining the amount of a fund's entitlement for transitional CGT relief.

Given it appears unlikely for this to be remedied in the Bill, ASFA intends to make an application to the Commissioner of the Australian Taxation Office for an exercise of remedial power to allow an alternate method for calculating the amount of an unsegregated fund's entitlement to transitional CGT relief.

ASFA, together with representatives of some of the large accounting firms, would be happy to discuss with Treasury possible alternate methodologies for calculating the amount of transitional CGT relief in unsegregated superannuation funds.

3. Inability of funds to pay a taxed income stream to a member

A number of member funds have expressed concern at the apparent prohibition on the paying of taxed income streams.

Take by way of example a 65-year-old member in receipt of an (untaxed) income stream, the value of which exceeds the Transfer Balance Cap. The excess amount is able to be part commuted and rolled back into the accumulation phase, where it can remain (with the earnings taxed at 15%) or be totally/partially cashed out.

Given the member is 65 it appears that this amount can only be cashed out as a lump sum and is unable to be paid as a (taxed) income stream. If the member wanted to continue to receive regular, periodic payments they would be compelled to apply for a lump sum benefit to be paid to them repeatedly – significantly inefficient, and costly, for member and fund alike.

It is important to note that, as the member is over age 60, the tax consequences of paying/receiving lump sums and income stream payments would be comparable. Neither payment is assessable as income, and so would be tax free in the hands of the member, whilst in both cases the earnings on the assets in the fund would be taxed at the rate of 15%.

There does not appear to be any compelling policy reason for this anomalous outcome. A member can achieve substantially the same result by making repeated applications for the payment of a lump sum benefit - which would in a manual, cumbersome, way effectively emulate an income stream - yet is precluded from commencing an actual (taxable) income stream – a considerably more efficient method to achieve the same outcome.

We strongly suggest that the apparent policy prohibition on the payment of taxed income streams be re-examined.

C. Specific comments on the Bill

ASFA member trustees have raised some issues with respect to the exposure draft of the Bill as follows:

1. Transition to retirement income streams (TRIS)

1.1. 'Enabling' TRIS to be in the retirement phase

The Explanatory Memorandum states that the amendments are to 'enable' a TRIS to be in the retirement phase.

The Bill states that a superannuation income stream is not in the retirement phase if it is a transition to retirement income stream and the person to whom it is payable has not satisfied a specified condition of release. This implies that – if the member has satisfied a specified condition of release – the income stream is 'automatically' considered to be in the retirement phase.

This has given rise to a number of questions/issue and practical considerations, as follows

1. Where a member has satisfied a specified condition of release - is it optional whether the TRIS is considered to be in retirement phase? Can a member choose that their TRIS is to remain a taxed TRIS (i.e. not be in retirement phase) until some point in the future when they may (or may not) elect for it to be in retirement phase? There does not appear to be a compelling policy reason not to allow this to be at the option of the member – especially as tax on earnings will continue to be payable at the rate of 15% for as long as the TRIS is not in 'retirement phase'.

2. Significantly, other than attaining age 65, trustees generally are not aware that a member has satisfied a specified condition of release – especially the most frequent one of 'retirement' – until the member applies for the payment of a related benefit. It is quite common that, when a trustee contacts a member who has reached the age of 65, the member informs the trustee that they met another condition of release (generally retirement) some time ago - frequently months and even years previously.

   Accordingly, if the satisfaction of a specified condition of release is sufficient to 'automatically' move a TRIS into retirement phase, this raises a number of significant practical considerations for trustees, including: -

   - the complexity and risk involved in 'back-dating' the effective date of the TRIS being in the retirement phase to the date the member satisfied the specified condition of release, should this be required. While funds are able to apply the tax free status from the date of notification, if a trustee were required to backdate the tax treatment to the date the member met the condition of release not only would this necessitate substantial and significant system changes it would create considerable ongoing complexity - especially when it occurred across tax years. Furthermore, given the short timeframe remaining prior to commencement, it would not be possible to make these system changes by 1 July 2017
   - given the trustee generally is aware of the member's date of birth it is unclear whether the trustee is expected to convert a TRIS into an untaxed retirement phase income stream automatically upon the member attaining the age of 65. There is a concern that, given that it may not be in the best interests of the member, member consent should be required (unless 'auto conversion' at age 65 is provided for under the product's governing rules). By way of example, 'auto conversion' may cause the member to breach their Transfer Balance Cap – possibly even for a second time.

Given

- the desirable policy outcome of flexibility and choice for the member; and
- the administrative difficulties which would be caused if TRISs were 'automatically' to be considered to be in retirement phase notwithstanding the fact that the trustee is not aware the member has satisfied a specified condition of release

it would be preferable if a TRIS were to be considered to be in retirement phase once the member has advised the trustee that they

- have satisfied a specified condition of release; and
- would like their TRIS to be in retirement phase (unless governing rules provide otherwise).

1.2. Transitional Capital Gains Tax relief

Section 294-110 of the TPA 97, as amended by the Bill, allows the transitional CGT relief to be applied to TRIS assets held throughout the pre-commencement period and that cease to be a segregated current pension asset of the fund at a time during the pre-commencement period or at the start of 1 July 2017.

The proposed legislative amendments do not resolve the issue that prevents funds from applying transitional CGT relief to assets, supporting continuing TRIS accounts that were not held continuously during the pre-commencement period (9 November 2016 to 30 June 2017).

A number of superannuation funds have no member level records for historical cost bases for existing TRIS accounts as, given prior to 1 July 2017 there is no tax applied to TRIS earnings, there was no need to record this detail in the past. Accordingly, these funds will not be in a position to be able to determine at a member level, from 1 July 2017, the amount of tax to be applied to earnings for assets that were purchased after 9 November 2016 which are supporting a TRIS as at 30 June 2017.

Allowing the transitional CGT relief to be applied to all assets supporting a TRIS as at 30 June 2017 would allow funds to reset the cost bases of these assets thereby allowing the fund to determine, at a member level, the amount of tax to be applied to earnings for all TRIS accounts from 1 July 2017.

Accordingly, we recommend a further legislative amendment to remove the requirement that to be eligible for transitional CGT relief an asset must have been a segregated current pension asset of the fund on 9 November 2016 and must have been held by the fund throughout the pre-commencement period.

1.3. Death of TRIS member

1.3.1. Inability to pay TRIS not in retirement phase to beneficiary

The legislation, as amended by the Bill, will not allow a TRIS not in retirement phase to continue to be paid to an eligible beneficiary, as nominated by the member, because a death benefit can only be paid to a dependent as an income stream if the income stream is in the retirement phase. This means existing nominations to pay a TRIS not in retirement phase to a nominated beneficiary will become invalid and a more limited range of death benefit nominations is available to members with a TRIS, which is not in retirement phase than those in retirement phase. This removes certainty and flexibility with respect to death benefit nominations for members of TRIS products not in retirement phase.

Accordingly, we suggest a legislative amendment to allow a TRIS not in retirement phase to continue to be paid to an eligible beneficiary, as nominated by the member, upon the death of the member.

1.3.2. Status of a TRIS on the death of a member

Member trustees have requested clarification as to whether death is a condition of release that will result in a TRIS ceasing to be subject to the 15% earnings tax within the fund, as death is not a condition of release, which is specified as one, which enables a TRIS to be considered to be in retirement phase.

1.4. Transitional issue – interaction of change in TRIS in retirement phase with Transfer Balance Cap

Some TRIS members who

- have satisfied a condition of release specified paragraph 307-80(2)(c) of the *Income Tax Assessment Act 1997* (ITAA 97); and
- previously did not have more than $1.6 million in retirement phase because TRISs were excluded

may now find, as a result of a TRIS (post meeting a specified condition of release) being included in the retirement phase, that they will exceed their Transfer Balance Cap on 1 July 2017. These members will have little time to seek financial advice and make arrangements to remove excess amounts from the retirement phase prior to 1 July 2017 to avoid paying additional tax.

If the recommendation under 1.1 above to allow members to elect if/when their TRIS is in retirement phase is adopted this will obviate the need for any transitional relief to address this issue.

If, however, the conversion of a TRIS to retirement phase remains 'automatic' on satisfaction of the specified conditions of release, we recommend that transitional relief (from Transfer Balance Cap tax) should be provided to affected individuals to provide them with sufficient time to seek financial advice and make arrangements to remove excess amounts from retirement phase.

2. Death benefits

2.1. Backdating of rollovers – current reversionary pensioners

Member funds have queried whether the backdating of the roll-over of death benefits will affect the current ability for a reversionary pensioner to roll back their death benefit pension to accumulation phase at least up to 30 June 2017. Clarification of this in the Explanatory Memorandum would be appreciated.

2.2. Rollovers – restrictions imposed by reg 306-10.01 of the Tax Regs – effective date

Items 17 and 18 of the Bill bring forward the application dates for the amendments made in items 5 and 6 of Schedule 1 to the *Treasury Laws Amendment (Fair & Sustainable Superannuation) Act 2016* (FaSSA) from 1 July 2017 to 9 November 2016.

The FaSSA amended the ITAA 97 to allow death benefits to be 'rolled over' and ensure they retain their character as 'superannuation death benefits' for tax purposes. In particular, the FaSSA removed

- the requirement in paragraph 306-10(a) of the ITAA 97 that a rollover superannuation benefit be a 'superannuation member benefit' (item 5, schedule 1); and
- sub-sections 307-5(3) to (3B) - which treated benefits arising from the commutation of a superannuation death benefit pension, within certain time periods, as superannuation member benefits (item 6, schedule 1).

The amendment to paragraph 306-10(a) of the ITAA 97 means that, prima facie, any death benefit can qualify as a rollover superannuation benefit, however, paragraph 306-10(b) contains a limitation that the rollover benefit cannot be one specified in the regulations. The *Treasury Laws Amendment (Fair and Sustainable Superannuation) Regulations 2017* (FaSS Regs) introduced reg 306-10.01 into the *Income Tax Assessment Regulations 1997* (Tax Regs). This regulation prevents a superannuation death benefit being rolled over unless it is paid in respect of a person who is eligible to take an income stream benefit as specified in sub-reg 6.21(2A) of the *Superannuation Industry (Supervision) Regulations 1994* (SIS Regs).

This has the effect that there will be no ability to rollover a superannuation death benefit for tax purposes unless the receiving fund is able to pay that amount as a superannuation income stream benefit.

Regulation 306-10.01 was to apply to superannuation benefits paid on or after 1 July 2017 (item 2 of schedule 10 of the FaSS Regs).

Member funds have identified that the Explanatory Memorandum does not provide any indication as to whether the application date for reg 306-10.01 will also be amended to 9 November 2016. Member funds have requested that the Explanatory Memorandum provide clarification on this point so funds are aware whether this limitation on the rollover of death benefits will also apply from the earlier date of 9 November 2016.

2.3. Identification of rollover benefits as superannuation death benefits

The Explanatory Memorandum to the FaSSA stated that amendments would be made to the rollover superannuation benefits statement/data as soon as practicable to ensure that rolled over death benefits are identified as such to ensure they continue to receive death benefits treatment, from both an income tax and regulatory perspective, in the receiving fund (paragraphs 3.94 and 3.95 EM). Superannuation death benefits may receive different income tax treatment in the hands of the beneficiary depending on the circumstances.

Under sub-reg 6.21(1) of the SIS Regs death benefits must be cashed as soon as practicable - either as a lump sum or an income stream - and under sub-reg 6.21(2A) a death benefit can only be paid as an income stream provided certain conditions are met. For these reasons it is critical that funds are able to identify whether a superannuation interest, which is rolled over into their fund, is a death benefit.

Steps are being taken by the ATO to facilitate the tracking of superannuation death benefits that are rolled over between funds by amendment of the rollover documents/data. The ATO is yet to release the proposed amendments to the rollover superannuation benefits statement/data and even when this has occurred it will take large funds some time to update their systems to facilitate capturing the additional information/date from the new form.

The Bill brings forward the start date for the expansion of the superannuation death benefits that can be rolled over which will create an increase in the volume of superannuation death benefits rolled - over between now and 30 June 2017.

Member funds have expressed a concern that the industry is not yet in a position to implement these changes to rolled-over superannuation death benefits - even meeting the former 1 July 2017 start date was proving to be a significant challenge. Given this, it will not be possible for most funds to track the information in respect of superannuation death benefits rollovers much before 1 July 2017.

Accordingly, consideration could be given to amending the Explanatory Memorandum to clarify that funds will not be required retrospectively to track and report on rollover superannuation death benefits before 1 July 2017 notwithstanding the proposed change to bring forward the effective date for additional superannuation death benefit rollovers.

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We would like to thank you for the opportunity to provide comments on the exposure draft *Treasury Laws Amendment (2017 Measures No. 2) Bill 2017: superannuation reform package amending provisions* and Explanatory Memorandum. We would welcome the opportunity to discuss with Treasury the matters raised in this submission.

Should you have any questions on any of the matters raised in this submission 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
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