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The General Manager
Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: cgt_super_roll-over@treasury.gov.au

Dear Sir \ Madam,

EXPOSURE DRAFT - THREE MONTH EXTENSION OF THE TEMPORARY LOSS RELIEF FOR MERGING SUPERANNUATION ENTITIES

The Association of Superannuation Funds of Australia (ASFA) would like to lodge this submission with respect to the above Exposure Draft ("the ED").

The Association of Superannuation Funds of Australia (ASFA) is a non-profit, non-political national organisation whose mission is to advance effective retirement outcomes for members of superannuation funds through research and advocacy. We focus on the issues that affect the entire superannuation industry. Our membership, which includes corporate, public sector, industry and retail superannuation funds as well service providers some of whom deal with self managed superannuation funds (SMSFs), has over 90% of the approximately 12 million Australians with superannuation as members. ASFA members manage or advise on the bulk of the $1.3 trillion in superannuation assets as at September 2010. ASFA is the only organisation that represents all types of superannuation funds and associated service providers.

The Exposure Draft

ASFA supports the proposal for the three month extension of the temporary loss relief for superannuation funds that merge, and the Government's policy objectives in respect of this measure. In our view, however, three months is an insufficient period for any such extension.

We have provided comments on some technical aspects of the ED and matters for further clarification as well as some comments with respect to the underlying policy.

(1) Comments on the Exposure Draft
Application of the measures

Based on reading proposed clause 5 in conjunction with the existing provisions in Division 310 of the *Income Tax Assessment Act 1997*, as amended, it is not clear that the measures apply to a merger where the "completion time for the loss relief" (as defined in section 310-10) occurs after 30 June 2011.

In particular, if the merger documentation has a successor fund transfer ("SFT") date such that the closing fund ceases to have any members on 31 July 2011, and all assets were transferred from the closing fund to the ongoing fund on that date, it would appear that:

- the completion time for the loss relief (as defined in section 310-10) would occur in the year ended 30 June 2012; but

- the transfers of assets would be deemed by clause 5 of the ED to occur in the year ended 30 June 2011 (but only for the purposes of section 310-45).

Accordingly, it would seem that, in these circumstances, the second condition, as stated in section 310-45(3), that the transfer events all happen in the income year for the closing fund that includes the completion time for the losses choice, would not be met.

ASFA submits that the Government should clarify whether the provisions in the ED are intended to operate in this way, and thus, that they have no application to any merger whether the SFT date (or more particularly, the date of transfer of members from the closing fund to the ongoing fund) occurs after 30 June 2011.

Clearly, this would restrict the relevance of the measures to those mergers where the primary aspects of the merger (i.e., the transfer of all members) occurred prior to 1 July 2011, but where, for whatever reason, certain asset transfers could not be completed at the same time.

It is possible that some funds may have interpreted the Government's original media release of 3 May 2011 as applying to all mergers occurring in the period to 30 September 2011, subject to the conditions in Division 310. In particular, whilst the Government clearly stated that its policy in respect of extension related to mergers already in progress, it did not specify what constituted a merger "already in progress", and it did not specify that the SFT date need to occur prior to 1 July 2011.

Accordingly, ASFA submits that the ED should include provisions ensuring that mergers are not denied the relief solely because the successor fund transfer date (or more specifically, completion dates for the loss relief) occurs after 30 June 2011.

When is the loss available to the ongoing fund?

Based on a similar reading of proposed clause 5 in conjunction with the existing provisions in Division 310 of the *Income Tax Assessment Act 1997*, as amended, it is not clear which year or years the loss becomes available to the ongoing fund (i.e., in which year or years is it transferred to that fund).

By way of illustration, consider a merger that occurs such that:

- the SFT date is 30 June 2011;
- the closing fund ceases to have any members on 30 June 2011, such that this is the completion date for the loss relief;
- most of the closing fund’s assets are transferred from the closing fund to the ongoing fund on 30 June 2011; and
- a small number of the closing fund’s assets were subject to legal impediments such that they are not transferred until 31 August 2011.

Proposed clause 5 ensures that the test in section 310-45(3) is met, as the transfers on 31 August 2011 are deemed to occur, <u>for the purposes of section 310-45 only</u> (our underlining), during the year ended 30 June 2011.

However, for all other purposes, including the general capital gains tax provisions relating to the calculation of the capital gain or loss in the closing fund, the transfers on 31 August 2011 would seem to be treated as occurring on 31 August 2011.

Accordingly, if the closing fund elects to apply the loss roll-over relief, does this result in:

1. the overall net capital loss, including the position at 30 June 2011 together with any new capital gains and losses on 31 August 2011, being available for transfer on 30 June 2011 (and thus available for offset by the ongoing fund against capital gains occurring on or after 1 July 2011); or
2. the overall net capital loss, including the position at 30 June 2011 together with any new capital gains and losses on 31 August 2011, being available for transfer on 31 August 2011 (and thus available for offset by the ongoing fund against capital gains occurring on or after 31 August 2011); or
3. the overall net capital loss, including the position at 30 June 2011 together with any new capital gains and losses on 31 August 2011, being available for transfer on 30 June 2012, being the end of the next tax year (and thus available for offset by the ongoing fund against capital gains occurring on or after 1 July 2012); or
4. the net capital loss position at 30 June 2011 being available for transfer on 30 June 2011 (and thus available for offset by the ongoing fund against capital gains occurring on or after 1 July 2011) but any net capital loss on the transfers on 31 August 2011 not being available for offset by the ongoing fund until that date or the following 30 June?

If 4 is the correct position, what would then occur if the transfers on 31 August 2011 viewed in isolation result in a net capital gain?

ASFA submits that the Government should clarify the manner in which the provisions are intended to apply, perhaps by using an example or examples similar to that above.

(2) General comments on the underlying policy

Ending the relief as at 30 September 2011 will have three major consequences: -

1. increased risk for currently merging funds;

2. significant barrier to future voluntary fund mergers; and

3. potential penalisation of members of funds compelled to merge

1. Increased risk for currently merging funds

Funds which are currently in the process of merging face considerable financial pressure to complete their mergers prior to 30 September, thus creating a risk that processes which, in the absence of CGT considerations, would naturally be finalised after 30 September will have their completion "brought forward" to ensure the merger is finished by this date. Compelling the early finalisation of a process represents an increased risk that it may not be completed as comprehensively or as accurately as it may have been had the process been allowed to "run over" the deadline.

2. Significant barrier to future voluntary fund mergers

Ending the CGT roll-over relief as at 30 September will create a significant barrier to future voluntary fund mergers.

In determining whether to merge with another fund, trustees of superannuation funds are under a trust law duty to act in the best interests of members. Accordingly, any threshold decision as to whether or not to merge, as well as the decisions as to the other fund and the timing, are all made taking into consideration the various benefits and costs to members of the proposed merger.

The impact of the CGT tax represents a significant consideration when determining the costs of a proposed merger and may well be a determining factor as to whether or not a merger proceeds.

APRA regulated funds were carrying a total of around $4 billion dollars in deferred tax assets as at the end of March 2011. It is believed that the recent sharemarket volatility, which may be expected to continue for some time, may have added anything up to another $5 billion dollars in deferred tax assets due to the reduction in share prices resulting in new tax losses.

Some funds currently are carrying deferred tax assets equivalent to 1.5% or more of member account balances, which would be lost if a merger were to go ahead without CGT relief, which given the volatility of the market may well increase. 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 approximately $3,500.

Accordingly, ending the CGT roll-over relief as at 30 September 2011 may cause the costs to members, through the extinguishment of deferred tax assets, to outweigh the benefits of any proposed merger.

The highly volatile, financial market conditions faced by superannuation funds will make determining the quantum of any CGT losses, which represent costs to members, extremely difficult. As such, any cost \ benefit analysis which is performed will need to introduce a wide margin of error into the analysis.

Given the risks that an adverse market movement close to completion date may generate significant CGT losses, which would result in the diminution of members' benefits, trustee may be compelled to decide not to take the risk of merging. This would have the consequence that mergers, which would otherwise have occurred but for CGT costs, will not take place.

3. Potential penalisation of members of funds compelled to merge

As outlined above, given the state of the investment markets, any funds which are required by APRA to merge are likely to realise considerable CGT losses upon merger. If such losses are extinguished and not able to be carried across to the new fund this could severely impact upon the value of member entitlements in the new fund.

We note that the Government's response to recommendation 10.11 of the review into the governance, efficiency, structure and operation of Australia's superannuation system stated as follows: -

> *"The Government … does support in principle, appropriate relief for superannuation funds which are required by APRA to merge in order to meet MySuper licence conditions and will consult with relevant stakeholders on implementation aspects".*

ASFA's policy position
Preferred position

ASFA submits that the extension should be on-going. Capital gains and losses resulting from the merger of two superannuation funds should not be crystallised on merger but instead the assets should be able to be carried forward in the accounts of the new fund.

The underlying policy principle of CGT is that part of a capital gain\capital loss resulting from a taxpayer having disposed of an asset should be treated as income\loss for the financial year in which the asset is sold, transferred or otherwise altered. This policy has integrity in circumstances where a taxpayer has control over the disposal of the asset, including where superannuation funds dispose of assets in the normal course of investing their funds under management.

It is arguable, however, that this policy should not extend to apply to superannuation fund mergers, where the underlying beneficial interest in the assets remains the same and only the legal ownership has been changed from one trustee to another. In these circumstances any capital gain\loss is not as a result of the final disposal of an asset to a third party but instead a CGT event is triggered merely by the change in legal ownership from one trustee to another, despite the underlying beneficial entitlements remaining the same.

ASFA submits that the distinction should be recognised between the circumstances where: -

- an asset is disposed of by being sold to a third party, whereby both the legal and beneficial ownership change, which creates a genuine capital gain\loss for the beneficial owner of the asset; and

- only the legal ownership is transferred to another, leaving the beneficial ownership unchanged, such that any capital gain\loss is only a notional gain\loss for the legal owner who was holding the asset in trust for the beneficial owner.

With respect to the latter, it should be borne in mind that: -

- the beneficiary member of the superannuation fund, who is the one who ultimately bears the tax consequences of any CGT gain\loss, does not have any control over the decision to merge funds or the consequent transfer of the legal ownership of the assets; and

- any CGT tax payable will be incurred by the beneficiary members, as opposed to the trustee as legal owner, through reduced unit prices or crediting rates which decrease the value of their superannuation investment.

ASFA submits that the law should recognise the distinction where the beneficial interest in the asset is not transferred and allow capital gains and losses to be rolled-over to the new legal owner.

The amendments contained in the *Income Tax Assessment Amendment (Capital Gains) Bill 1986,* which introduced the CGT reforms, allowed rollovers for asset ownership changes associated with specified types of business reorganisations where no change occurred in the underlying ownership of the asset concerned or where the underlying assets against which the taxpayers had a claim did not change.

The policy rationale behind this recognises that, where asset ownership changes are consequent upon the reorganisation of a business, and no change occurs in the underlying ownership of the asset, any CGT gains or losses should be able to be rolled-over to the new entity. We submit that our proposal to permit the roll-over of CGT gains\losses where only the legal, and not beneficial, ownership of the assets has changed is entirely consistent with this.

Given the stated policy objective that funds should consider merging to achieve scale, as this ultimately will be to the benefit of fund members and the community generally, it is arguable that CGT roll-over relief should be ongoing.

Rollovers of CGT gains and losses has been allowed previously to promote industry consolidation and to provide relief as trustees transitioned to the SIS and RSE licensing regimes. This relief facilitated rollovers and ensured that the members of the funds were not penalised by incurring CGT tax costs.

ASFA agreed with, and welcomed, the decision that it was determined to be appropriate to grant relief during these transitional periods.

This, however, begs the question as to why it is not considered appropriate that relief be available on an on-going basis? Why should members whose fund are merged outside a transition period bear the cost of CGT tax, whilst members of funds who merge during a transition period do not?

This has the potential to create significant inequities between members of different funds, based on no criteria other than the timing of their fund mergers.

Alternate position

Given the Government's stated position – that it supports the provision of relief for superannuation funds which are required to merge – ASFA submits that the CGT roll-over relief for all merging superannuation entities should, as a minimum, be extended until after the end of the transition period to MySuper - 30 June 2014.

Given the changes to the existing registrable superannuation entity licensing regime which are to be introduced to implement the Stronger Super reforms, in particular MySuper, funds may be compelled to merge in circumstances of extreme market volatility not of their choosing.

In the Stronger Super – Government Response the Government stated on Page 6 that: -

> *"The key features of MySuper will be:*
>
> - *new duties for trustees, including a specific duty to deliver value for money as measured by long - term net returns, and to actively consider whether the fund has sufficient scale".*

Given the stated Government objective is for funds which cannot achieve scale through organic growth to consider, or be compelled, to merge with another fund, it would be somewhat anomalous if the inability to carry forward CGT losses, or gains, generated by a merger were to prove to be an impediment to such mergers taking place.

We thank you for providing us the opportunity to make this submission and more generally for the opportunity to participate in the consultation process.

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If you have any queries or comments regarding the contents of our submission, please contact our Senior Policy Adviser, Fiona Galbraith, on (03) 9225 - 4021 or 0431 490 240 or by email to fgalbraith@superannuation.asn.au.

Yours sincerely

D. Graus

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