6 April 2017

The Hon. Kelly O'Dwyer MP
The Minister for Revenue and Financial Services
PO Box 6022
House of Representatives
Parliament House
Canberra ACT 2600

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Dear Minister,

Proposed changes to superannuation reform legislation

Thank you for your letter dated 28 March 2017 regarding proposed changes to the superannuation tax reform package. We appreciate you letting us know about the proposed changes so we can inform our members of them.

Generally, we are concerned by the proposed changes regarding limited recourse borrowing arrangements (LRBAs) which will affect self managed superannuation fund (SMSF) trustees and their advisers. Implementing the proposed amendments with a 1 July 2017 start date does not allow adequate time for SMSF trustees to adjust strategies for existing LRBAs and we are concerned by the complexity and potential unintended outcomes of the proposed changes.

We support the proposed amendments regarding transition to retirement income streams (TRIS) where a TRIS holder satisfies a nil chasing restriction condition of release to ensure their tax treatment is the same as an account based pension (ABP) but believe a simpler approach can be taken to achieve the policy outcome.

Our detailed views on the proposed measures are set out below.

Limited recourse borrowing arrangements

Timing of implementation

We are concerned that the Government's plans to make further amendments to the transfer balance cap (TBC) and total superannuation balance (TSB) rules to apply from 1 July 2017 will not provide SMSF

trustees with an appropriate amount of time to be able to adjust their retirement savings strategies to meet the new requirements.

While SMSF trustees have known about the transfer balance cap and restrictions on making non-concessional contributions since the 2016 Budget and have been able to plan for the limits on assets in retirement phase since that time, they will not have similar or adequate time to plan for these changes. This can severely disrupt retirement savings plans of those who have in good faith used LRBAs to build their retirement savings in accordance with the existing tax and superannuation laws. This potential negative disruption is exacerbated by LRBAs being long-term investment structures, where SMSF trustees have strategies in place that can take decades to fulfil. Requiring these SMSF trustees to change their long-term retirement savings strategies in a critically short period is manifestly unfair.

Accordingly, we urge the Government to consider delaying the start date or the effect of these proposed LRBA changes to allow SMSF trustees and their advisers sufficient time to consider how the changes will affect them and what actions they may need to take as a consequence. This could take shape in the form of either:

a) Grandfather existing LRBAs from the proposed amendments and only apply the law to LRBAs put in place from 1 July 2017 onwards, or
b) Making the start date for the changes 1 July 2018, giving SMSFs with LRBAs 12 months to consider how the changes affect them and take necessary action, or
c) With a 1 July 2017 start date, allowing superannuation funds with LRBAs in existence just prior to 1 July 2017 a 12 month period until the LRBA counts to their TSB and TBC.

Total Superannuation Balance Proposal – better targeting

The SMSF Association understands the Government's desire to ensure that LRBAs are not being used to circumvent the TSB limitation on NCCs. However, we believe the decision to include the outstanding balance of an LRBA in an individual's TSB unfairly affects those who are genuinely using an LRBA to build retirement savings, not circumventing the NCC cap. Further, we do not believe that using an LRBA to circumvent the TSB rules to make further NCCs will be a common place strategy for SMSFs given its complexity and the limited circumstances in which the strategy can be carried out.

The following example illustrates how the new rules may unfairly affect an SMSF member legitimately using an LRBA to build their retirement savings:

> *An SMSF member is 40 years old. He is in the process of acquiring business real property (BRP) from himself. The property was purchased some years ago as the ideal BRP for his engineering business, forming a key part of his overall retirement strategy. He did not have sufficient cash at the time within his SMSF to fund the deposit and instead purchased it in his private capacity.*

The member has been diligently contributing to the SMSF and now has a 35% deposit and is conducting an LRBA to acquire the BRP to fulfil part of his long term retirement plan.

The property is valued at $1.45m. The proposed LRBA changes will result in the member having a super balance of $1.45m plus the retained capital in the SMSF.

Within 3-4 years he will exceed the $1.6m TSB and will be precluded from future NCCs.

There is no potential mischief in the above as the member has not met preservation age and cannot access the capital from his super fund.

This type of arrangement is genuinely motivated by growing retirement savings, not circumventing the TSB rules but will unfairly be caught and negated by the proposed amendments.

The proposed amendments will also create significant problems for SMSF members who would be relying on future NCCs to their SMSF to pay off their established LRBAs if the outstanding value of the LRBA is included in their TSB. This will create significant disruption to people' retirement savings plans.

For example, take the following simplified SMSF member:

- *As of 30 June 2017 they have following assets and liabilities:*
    - *$400,000 in Australian shares and ETFs*
    - *$400,000 cash*
    - *$800,000 commercial property*
    - *$400,000 LRBA*
- *Under the current law their TSB would be $1.2 million and they would be eligible to make NCCs next financial year.*
    - *This would facilitate further paying off the LRBA through NCCs.*
- *Under the proposed amendments their TSB would be $1.6 million and they would be precluded from making any NCCs in the next financial year.*
    - *If they were relying on making NCCs to service the LRBA they will now be placed in a position where their only alternatives are:*
        - *To sell their Australians shares and ETFs or use their cash to pay-off the LRBA, or*
        - *Sell the commercial property asset to discharge the LRBA.*

In this example, both the strategies are suboptimal for their retirement savings but will be forced upon them by the proposed amendment. In addition, this will most likely effect SMSF members approaching retirement (e.g. in their early sixties) who have had long-term plans to make NCCs at this time in their life to discharge their LRBA because they expected to have increased financial capacity to make NCCs. Research by Rice Warner conducted for the SMSF Association in October 2016 on SMSF contributions conclusively showed that SMSF members only begin to make significant voluntary

(concessional and NCCs) from age 56 onwards.[1] Consequently, the Government's proposed changes are likely to affect people who have the least amount of time to change their retirement strategies to accommodate the proposed amendments.

Due to these significant negative impacts potentially created by the proposed TSB amendment, we believe the Government should look to limit the application of the proposal to include LRBAs in an individual's TSB and make it better targeted.

The "mischief" the Government is seeking to prevent is created by SMSF members withdrawing funds from their SMSF tax-free and using an LRBA to return it to the fund, and in the meantime, making additional NCCs. This requires The SMSF member to be able to receive benefit payments from the fund and use a related party LRBA to ensure that they are in the same economic position but effectively reduce their TSB. The LRBA amendments could be better targeted by focussing on these elements that are required to defeat the policy intent of the TSB restriction on NCCs.

We understand that it would be unlikely for an SMSF to execute the Government's targeted strategy through a retail lender. Retail lenders' credit policies generally preclude older SMSF members (i.e. those who have satisfied a condition of release) from accessing funding for LRBAs due to their ability to make necessary contributions for repayment and also because the fund's earnings are often required to pay pensions in retirement phase. Again, this lends support to better targeting the proposed amendments.

Better targeting could occur through either:

a) Restricting the proposed amendments to related party LRBAs, or
b) Ban related party LRBAs from 1 July 2017 onwards so they cannot be used to exploit the TSB rules, or
c) Restricting the proposed amendments to people who met a nil cashing restriction condition of release (i.e. they can withdraw tax-free lump sums from their SMSF), or
d) A combination of the above recommendations.

By restricting the application of the proposed amendments to SMSF members who are able to actually use an LRBA to exploit the TSB NCC rules, this would avoid unfair outcomes for SMSF trustee who are using LRBAs in a legitimate fashion to build their retirement savings, as illustrated in the example above. We strongly encourage the Government to consider these alternative approaches so that people legitimately saving for their retirement through the use of an LRBA are not unfairly disadvantaged.

[1] https://www.smsfassociation.com/wp-content/uploads/2016/10/Member-Research-SMSFA-Rice-Warner.pdf

Transfer balance cap credit proposal – interest payments

The proposal to include repayments of principal and interest on an LRBA is concerning as we do not believe interest payments on an LRBA result in a transfer of accumulation funds to retirement phase (unlike principal repayments). Interest payments are an investment cost, not a transfer of wealth, as a principal repayment is viewed.

To avoid this issue, we suggest interest payments should not to be included in the proposed amendments. Alternatively, we suggest using a gross asset valuation of assets that are under a LRBA for TBC purposes. This will have the same effect of including payments against an LRBA as TBC credits without the added complexity.

We also note that this LRBA strategy requires a fund to use the segregated method to calculate exempt current pension income to be effective (i.e. the LRBA asset is in retirement phase, while capital and interest repayments are made from assets held in accumulation phase). Our understanding is that it is only a small minority of SMSFs that have a member in pension phase which use the segregated method. Accordingly, we believe that complex changes are being made to the TBC will only effect a few SMSFs, especially given the TBC will apply to less than 100,000 SMSFs according to the Government's estimates. We believe then it is essential for these amendments to be legislated to apply only to segregated funds and be narrowly targeted only to the concerned behaviour, so as to not unnecessarily affect the rest of the SMSF population.

Practical concerns

In addition to the policy issues we have raised above, there are a number of implementation issues for these LRBA proposals that concern us.

- The proposals envisage allocating value of an LRBA and related repayments to an individual member in an SMSF. It would be extremely rare for an entire LRBA and related asset to be allocated to one member's account within an SMSF. This will make it difficult to administer and potentially create inequitable and unfair results.
- Real-time reporting of LRBA payments for TBC purposes will be an onerous requirement for SMSF trustees and incur significant additional red tape costs for limited real benefit.
- The Australian Taxation Office does not collect the majority of the data needed to implement or monitor these proposed changes.

Transition to retirement income streams

We support and welcome the Government's proposed changes to ensure that where a TRIS holder satisfies a nil cashing restriction condition of release their TRIS is treated in the same way as an ABP. However, we believe that the proposed amendment is more complex than required.

By allowing a TRIS to continue but receive a tax exemption for its asset's earnings the superannuation is made more complex by having two types of TRIS – one with taxable earnings and one without. An extension of this is also one type of TRIS will count towards the TBC and the other will not. In addition, if a TRIS retains its characterisation after a TRIS holder satisfies a nil cashing restriction condition will it need to comply with the TRIS maximum drawdown rules?

We believe that these complexities can be avoided by adopting a simpler approach by amending the *Superannuation Industry (Supervision) Regulations* 1994 so that where a TRIS holder satisfies a nil cashing restriction condition of release their TRIS automatically becomes an ABP. This should operate by deeming the pension to be an ABP without the TRIS ceasing so that the proportioning rule does not have to be reapplied at the time the TRIS automatically becomes an ABP. This will avoid the complexities cited above.

Further Consultation

Given the complex nature of the amendments proposed by the Government we strongly encourage the Government to undertake consultation on draft legislation for the amendments.

If you have any questions about our concerns or proposed changes to the Government's amendments please do not hesitate in contacting us and we will make ourselves available at your convenience.

Yours sincerely,

Andrea Slattery
Managing Director/CEO
SMSF Association