28 March 2019

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

Email: superannuation@treasury.gov.au

Dear Sir/Madam,

SMSF ASSOCIATION SUBMISSION ON MINOR SUPERANNUATION TAX REFORM TECHNICAL AMENDMENTS

The SMSF Association welcomes the opportunity to make a submission on the Government's minor superannuation tax reform technical amendments.

The 1 July 2017 superannuation changes and the complexities dealt with by these amendments have caused significant concern for individuals with legacy pensions and death benefit rollovers with untaxed elements. Accordingly, we support these measures aimed at resolving those issues.

Debit value for certain capped defined benefit income streams

The SMSFA supports the Government's intention to correct an error in the way that market-linked pensions (MLP) are valued under the transfer balance cap (TBC) when they are commuted or rolled over, resulting in a nil debit. This will ensure individuals will be able to commute their MLPs effectively and as intended.

The proposed amendments apply a different methodology for calculating the TBC debit value compared to what is currently specified by the *Income Tax Assessment Act 1997* and the explanatory memorandum (EM) to the Treasury Laws Amendment (Fair and Sustainable Superannuation) Bill 2016.

Therefore, we believe there are three key areas that need to be resolved in order to ensure that the new legislation is effective, not overly complex and fair.

1. Government must be satisfied that the original MLP debit formula is unable to be fixed.
2. Government must be satisfied that their new MLP formula works and is appropriate.
3. Government must ensure that there is an appropriate transition or consideration for individuals who have used the original MLP formula and the Australian Tax Office (ATO) administrative concession.

Additionally, we believe the Government should consider allowing an amnesty to convert legacy pensions, including market linked pensions to account based pensions, to reduce the number of complex pensions left in the superannuation system.

Amending the original formula

As stated, the proposed amendments apply a different methodology for calculating a debit value than what was originally outlined in the current legislation and the amending Bill's EM. This infers that the original formula is unable to be amended to ensure that it operates as the original legislation intended.

We understand there may be an issue regarding the determination of the 'next pension payment' when individuals have already taken their full pension for a financial year and cannot fairly determine the 'next payment' until the end of the year. Individuals could then exploit the system through the 'term remaining rounded up' aspect to get favourable TBC debits. Individuals using the amending Bill's EM (Examples 3.30 and 3.31) could follow a view which would create TBC gaps and the ability to allocate more capital to retirement phase. However, we believe this was the intended nature of the 'special value' framework and as such is not being exploited.

The exact reason for a change in methodology has not been explained in the current draft materials. As such, we believe it is essential for this to be provided.

The problem with the original application of the formula was that after a full commutation there was no remaining and no annual entitlement to use in the calculation of a debit. Therefore, the debit became nil when calculating the special value.

We believe the original formula can be amended to allow the calculation to be undertaken as if the commutation did not take place and by using the annual income entitlement at the start of the income year. If the commutation did not occur, then the individual would be able to determine the number of years remaining and annual entitlement. This number would be used as the special value.

This is similar to the calculation when a retirement phase pension ceases due to the failure to pay the minimum pension. The pension ceases from the start of the financial year, but for TBC purposes only, the credit arises at the end of the income year.

We believe the 'annual entitlement' could be amended as such:

> (a) dividing the amount of the first *superannuation income stream benefit you *were* entitled to receive from the income stream *in the current income year* by the number of whole days to which that benefit relates;

Amending the original formula ensures that individuals who have already commuted their MLPs under the intention of the current legislation will not be adversely affected. It provides a 'fix' to the original formula and ensures continued consistency in the legislation.

We would be happy to work further with Treasury on the drafting of any required changes to ensure the final legislation is technically correct.

The new formula

If it is decided that the old formula cannot be amended appropriately, it needs to be ensured that the new formula will work and is appropriate moving forward.

Instead of the MLP debit being calculated by the annual payment and term remaining at the time of commutation, the debit will now be determined by the original special value credit less any pension payments or entitlements taken previously and the greater of either the minimum entitlement the individual is required to take in the year of commutation or the entitlement the individual received in the year of commutation.

The new formula's intent seems to aim to follow the concept of having a special value debit that reduces over time, akin to how an account based pension (ABP) balance would as someone takes pension payments. However, this is inconsistent with the general approach of pension payments not creating a TBC debit for ABPs, along with the inconsistency that earnings do not affect the special value of an MLP debit as they do for an ABP debit which uses market value of capital supporting the pension. As highlighted in the amending Bill's EM examples, the special value of the debit for the individual was lower than their special value credit due to the fall in the amount of terms and annualised payment.

We believe this new formula will result in a lower debit value than originally intended. For example, applying this approach with the example of Daniel in the Draft Bill's EM, the transfer balance debit is $17,000 lower than if the original formula was applied.

In particular, the interpretation of paragraph 294-145(6A)(a) is important. The draft EM does not clarify if 'total payments' means only last year's entitlements, all previous entitlements, or entitlements since 1 July 2017. Furthermore, it is even arguable that a strict interpretation could be construed to mean all payments the individual is entitled to receive for the remaining term of the MLP. We believe this drafting must be amended for clarity.

Our belief is that the intention is to calculate all previous payments made under an MLP since 1 July 2017. We would be unsure of the logic if this was restricted to just one financial year prior. If it is to include all previous income stream benefits, this will have the complication of causing calculations where the sum of all payments may be higher than the original special value of the credit. This would mean an individual would not be able to commute their MLP effectively.

The new legislation may also cause potential excess transfer balance amounts for members who have followed the intention in the original legislation and commenced ABPs after commuting their MLP. We provide an example of a potential excess transfer balance account for a member under the new interpretation compared to the old interpretation.

Using Daniel from the draft EM with a commutation date of 1 July 2017 and the interpretation that 'total payments' only includes last year's entitlement.

- The special value credit is $1,829,697.
- The debit starts off as $1,829,697 and is reduced by MLP payments in the 2016/17 year of say $91,000. (Depending on the interpretation this may be more). This leaves a transfer balance account of $91,000 in credit.
- Following the intent of the original legislation, Daniels debit would be $1,829,697 and reflect the original special value credit.

If the market value of Daniels MLP at 1 July 2017 was $1.3 million, he may have transferred $300,000 of accumulation benefits to a retirement phase ABP to maximise his TBC. However, after applying the new approach, he now has an excess transfer balance account of $91,000.

Therefore, all calculations of debit value for commutations for MLPs since 1 July 2017 that advisers, accountants and administrators have used may now be incorrect.

The SMSFA believes if the new formula is to go ahead it should be drafted to satisfy that all payments from 1 July 2017 are to be included in the calculation for the MLP debit.

Furthermore, as we discuss below there must be also be appropriate consideration for those who have relied on the original intention and the ATO's practical compliance approach to this.

Appropriate consideration for those who have relied on the original formula

Apart from adopting a process that aligns with the Government's original intention, we believe it is appropriate that impacted members who have relied on the original application of the formula are treated appropriately.

Determining how individuals who have already reported under the ATO's practical compliance approach will be catered for is essential to this. Will individuals be able to apply keep their current arrangements under this approach or will they be forced to apply the new legislation? If the latter is true, then we believe a member concession is appropriate.

We think it is appropriate that any member who encounters an excess transfer balance tax situation through the initial adoption of the new MLP debit formula should be able to rectify this without penalty. This is due to the retrospective change of the new formula which will have the effect of providing lower debit amounts causing excess transfer amounts.

Amnesty for legacy pensions

In our 2019-20 Federal budget Submission, we advocated for an amnesty to allow unrestricted conversion of legacy pensions to account based pensions. We believe the complex amendments in the draft law required to ensure that legacy pensions operate effectively under the TBC rules illustrates the need for the Government to proceed with this suggested measure.

We believe a transition period that allows for trustees to commute and recommence legacy pensions as account based pensions with the value of the assets which underlie the pension counting to their TBC as common sense.

An amnesty to 'flush out' legacy pensions would also give the opportunity for individuals to take up new more innovative retirement income products rather than being locked into legacy products. This is another significant benefit which will allow individuals with legacy pensions to better drawdown on their savings and address longevity risk.

A transition period would remove the restriction and penalties around the commutations of these pensions. This would include allocating the reserve accounts that are consistent with these pensions to capital supporting an account based pension and resolving current uncertainty of how reserves interact with the TBC.

Our full Budget Submission can be read here: https://www.smsfassociation.com/smsf-association-2019-20-budget-submission/

Death benefit rollovers

The SMSF Association supports the Government's intention to ensure that death benefits that include life insurance proceeds are not subject to tax when they are rolled over to a new superannuation fund. This will ensure the law acts with the intention to ensure that individuals can rollover their superannuation death benefits without adverse results to other funds.

Our understanding of the legislation is that the proposal will exclude the untaxed element in the death benefit rollover from being included in the receiving funds' assessable income. This means that the sending fund will need to calculate and notify the receiving fund of the untaxed element which is to be disregarded. This will meet the intention of the law.

However, we believe a simpler administrative approach would be to amend section 307-290 of the ITAA 1997 to ensure that an untaxed element is not created when a death benefit lump sum is paid on rollover to another fund. This would ensure that trustees will not need to calculate a figure that is immediately disregarded.

If the Government chooses to persist with the approach in the draft Bill it is also unclear whether the untaxed element included in a death benefit rollover will form part of the member's taxable component untaxed element in the receiving fund or whether the trustee has the option of treating the disregarded amount as forming part of the members taxable component taxed element.

If it is the intention that the receiving fund trustee would be required to record the amount of any untaxed element received via a death benefit rollover and reflect that in the beneficiary's death benefit income stream tax component split, this will result in significant costs for all defined contribution funds to modify their fund administration systems to include untaxed elements as part of a member's income stream tax components.

In addition, requiring funds to record an amount of benefit as untaxed element would then result in the loss of the 15% pension offset on that proportion of the beneficiary's income payments made up of untaxed element where the death benefit income stream would be subject to taxation. For example, in the scenario where both the deceased and beneficiary were under age 60 at the time of death. This will effectively apply a tax to the rollover which is not the intent of the amendment nor the original legislation.

If you have any questions about our submission, please do not hesitate in contacting us.

Yours sincerely,

John Maroney
CEO
SMSF Association

ABOUT THE SMSF ASSOCIATION

The SMSF Association is the peak professional body representing SMSF sector which is comprised of over 1.1 million SMSF members who have $727 billion of funds under management and a diverse range of financial professionals servicing SMSFs. The SMSF Association continues to build integrity through professional and education standards for advisors and education standards for trustees. The SMSF Association consists of professional members, principally accountants, auditors, lawyers, financial planners and other professionals such as tax professionals and actuaries. Additionally, the SMSF Association represents SMSF trustee members and provides them access to independent education materials to assist them in the running of their SMSF.