Superannuation and tax technical amendments

Submission to Treasury

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1 About the Financial Services Council

The FSC is a leading peak body which sets mandatory Standards and develops policy for more than 100 member companies in Australia's largest industry sector, financial services.

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

The financial services industry is responsible for investing almost $3 trillion on behalf of more than 14.8 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange, and is the fourth largest pool of managed funds in the world.

2 FSC general comments

The FSC commends the Government for the changes in the draft legislation and regulations – several of these changes address specific requests by the FSC.

The FSC's comments below are directed at ensuring the draft proposals work as intended with minimum cost to funds and members. All references relate to the exposure draft legislation and regulations unless otherwise specified.

In relation to timing, the FSC notes there is significant urgency in dealing with the regulations amending the life-expectancy period for innovative income stream products discussed in this submission in Section 4.3. This is because these regulations are required to support the new means test rules applying from 1 July 2019. Therefore, the FSC considers these regulations should proceed as quickly as possible, regardless of any additional work required on other parts of the draft legislation and regulations – particularly any work required to consider the changes proposed by the FSC in Section 3.1 of this submission.

As there are a number of successor fund transfers (SFTs) occurring in the industry, it is also important for the regulations relating to SFTs progress without delay.

3 Legislative amendments

3.1 Valuation of market-linked pensions under the transfer balance cap when they are commuted or rolled over, resulting in a nil debit

The FSC supports the intent of these amendments, contained in Schedule 1, Part 1, Item 1 and Item 2 of the exposure draft legislation, including the broadening of the scope to include market linked annuities, and life expectancy pensions and annuities. The industry welcomes this change which will assist to ensure consumers with a variety of different pension products are treated consistently.

We do however have concerns regarding the calculation method for determining the debit value for certain capped defined benefit (**DB**) income streams, outlined below.

The FSC has a concern that the proposed calculation methodology will not address technical complexities and administration issues from the implementation of the Fair and Sustainable Superannuation Reforms – particularly for market linked income streams and (more broadly) legacy pensions. The FSC has raised some of these concerns previously.

The issues with the proposal include:

- As market-linked pensions cannot be commuted back to accumulation or out of the super system, the consumer will be forced to pay excess transfer balance tax on a daily notional earnings amount for an indefinite period of time, including the period after the pension term has ended.
- The proposed approach of using actual income in the calculation methodology for transfer balance cap purposes presents practical problems for super funds and the ATO as currently, for market-linked pensions, there would be no record of total income paid over the product's history.
- The retrospective application of the new calculation methodology creates unnecessary administration issues, additional costs for consumers, and may create adverse outcomes for consumers.
- The effects of using actual income received in the calculation methodology under certain assumptions may lead to perverse outcomes where actual income exceeds the special value. This will depend on how subsection 294-145(6A)(a) is interpreted on a prospective basis. If it results in the cumulative sum of previous income streams benefits that the customer was entitled to receive from the income stream before the start of commutation, which is the approach taken in the draft, then we believe under certain scenarios (i.e. high earnings and commutation occurring over 2 years from the transfer balance) this could result in a negative debit (effectively a credit). This result would penalise a retiree permanently for the solid performance of their fund. We would welcome additional clarity from Treasury on this point.

Preferred approach: We believe it would be preferable to fully address the substantial complexities and technical administration issues that have arisen with legacy retirement products. This would ideally be achieved by introducing an amnesty which would allow these market-linked pensions and annuities to be transitioned into more contemporary retirement income stream products where they will be assessed according to the $1.6m transfer balance cap (**TBC**). That is, the amnesty would allow trustees to commute and recommence these pensions as account-based pensions with the value of the assets which underlie the pension counting towards their TBC.

This approach would provide access to more modern retirement income products for members, promote efficiency and reduce operational risks. This would also reduce the number of legacy products – the problems with legacy products are well known.[1]

[1] The Productivity Commission raised significant concerns with legacy superannuation products in its final report into superannuation. See also the FSC Pre-Budget submission, available from: https://fsc.org.au/resources/resource-detail/?documentid=324ee583-4341-e911-a96b-000d3ae13a46

Market linked income streams were introduced from September 2004 and are now generally closed or no longer offered to new members. These are complex products and it can be difficult for members to understand the operation of these products in detail, particularly how the product is assessed for the TBC – partially because the TBC was not designed with these legacy pensions in mind. These pensions are difficult to administer, explain and advise on. Allowing members of market linked and other legacy income streams to easily transition their benefits into a more modern retirement product such as an account-based pension would provide these members greater flexibility and choice in managing their retirement benefits.

The amnesty would be optional for market linked pensions that have already been commuted.

Second preference: An alternative to the amnesty proposed above is for market linked income streams and annuities that commence after 1 July 2017 to remain as capped DB income streams. This would allow holders of market-linked pensions and annuities to transfer product providers without causing an excess transfer balance account. To be consistent with other capped DB income streams, such as lifetime pensions and annuities, the debit value on rollover would equal the starting special value less previous debits, and the subsequent credit would remain as annual entitlement multiplied by the remaining term. In order to maintain existing rules relating to capped DB income streams, there would be no excess transfer balance amount generated to the extent that the excess is attributable to the capped DB income stream.

Market-linked pensions were originally classified as capped DB income streams and assessed differently under the TBC due to commutation restrictions that apply to these types of income streams – in particular, market-linked pensions are generally restricted from commutations unless the member is rolling over 100% of the benefit to another market-linked pension. While this different treatment may not cause a person to breach the TBC, an individual will be subject to additional taxation rules to ensure that different pension schemes are subject to broadly commensurate tax outcomes.

While this is our second preference as a standalone option, we also note this option could be provided *in addition* to the FSC's first preference option.

Third preference: Amend the calculation to address inclusion of income stream benefits in calculation

If the above solutions are not adopted, then the FSC recommends an amendment to address concerns about the prescribed calculation (for full and partial commutations) relating to inclusion of income stream benefits in the calculation of the transfer balance account (**TBA**) debit. The inclusion of these income stream benefits has the effect of reducing the original TBA credit. We note that no other income stream requires the inclusion of income payments in determining an individual's TBA.

In most cases, income stream providers do not store the original TBA credit value, or any subsequent TBA debit values, for capped DB income streams. Rather these values are calculated at the time reporting is required. Requiring providers to reference these values would unnecessarily increase administration costs. By contrast, the ATO should hold the original TBA credit value in respect of the income stream, as reported by the provider.

Therefore, the FSC submits the TBA debit should not include reference to income stream payments, and should be calculated or automatically processed by the ATO without any need for income stream providers to report this TBA debit, if providers indicate that the relevant capped DB income stream has been commuted in full – potentially under MAAS/MATS reporting.

In instances where there has been a partial commutation of certain capped DB income streams, the FSC proposes that the value of the TBA debit reflect the amount of the superannuation lump sum that results from the partial commutation.

3.1.1 Application date

We also note the amendment technically applies as if the calculation formula applied from 1 July 2017 and every provider should have calculated and reported this value under the revised formula. This raises concerns because penalty interest can apply from the date a TBA balance exceeds a member's TBC. Therefore, we submit that members should not be penalised for breaching their TBC as a result of any re-reporting by Funds or the ATO automatically processing the TBA debit (as under the FSC's preferred model).

This is an important change because it will take some time for providers/the ATO to amend their systems to make the relevant calculations. The longer this takes, the greater the potential penalty interest charge on members, if the calculation shows the member actually breached their TBC at the time they commuted their income stream.

If this issue is not addressed, this will mean the law is changed retrospectively and then some members would be penalised for inadvertent breaches of a retrospective law.

To stop the penalty applying, options include ignoring any excess above the cap due to re-reporting of the TBA debit, or ensuring the TBA debit is only applied to a member's account on the date it reported by the provider/processed by the ATO, and not the date of the commutation.

As the proposed changes are effective from 1 July 2017, they will impact all commutations for the applicable capped DB income stream products already reported. As part of these amendments we would appreciate clarity on how the approach to reporting any amendments to prior commutations will be managed to limit adverse outcomes for members. This should ideally be facilitated by the ATO, with consideration of relief from any applicable reporting timeframes to income stream providers.

3.2 Ensuring Death Benefit Rollovers are not subject to tax

The comments below relate to Schedule 1, Part 1, Item 3 of the exposure draft legislation.

The FSC supports the intent behind this change, which is to remove unintentional tax liabilities on rollover of death benefits. The FSC has specifically recommended this type of change.

However, we have concerns that the proposal does not achieve the intended outcome.

The proposed legislative amendments to s295-190(1) has the effect that an untaxed element generated as part of a death benefit lump sum is not assessable income for the recipient super fund. This results in a 15% tax not being applied to an untaxed element on the receipt of a death benefit rollover. We support this outcome as it ensures the member is not adversely affected by the rollover.

However, no amendment has been proposed to s207-290 in relation to determining the tax components of a death benefit superannuation lump sum. As such, it appears that an untaxed element could still apply under that section. Although any such untaxed element will not be treated as assessable income to the recipient fund, it still implies that the untaxed element is part of the account balance.

This approach does not seem to adequately address the issue of unintentionally taxing recipients of a death benefit income stream. This raises several issues:

- This approach will result in ongoing administration costs and complexity for funds. The fund rolling over the death benefit super lump sum will still be required to calculate an untaxed element, and the recipient fund needs to ensure this is not included in their taxable income.
- Under the draft s295-190(1) untaxed elements that are not produced due to s307-290 must still be included as assessable income to the recipient fund. This suggests that two types of untaxed elements must be recorded by funds.
- All superannuation funds would need to implement system changes to update the SuperStream Rollover message and the Rollover Benefit Statement issued to members to cater for different types of untaxed element which adds significant administrative complexity and costs.
- If the member commences a death benefit income stream, the super fund will be required to withhold PAYG tax from the income stream payments relating to the untaxed element – this runs against the intention of the policy.
    - We note most APRA funds do not operate untaxed schemes, as a result this is likely to lead to the majority of super funds not being able to administer these types of income streams. The unintended consequence is that funds that currently accept death benefit rollovers may no longer be able to do so.

The FSC has previously advocated for an alternative option to address the taxation of death benefit rollovers.

The FSC's preferred alternative is to modify section 307-290 of ITAA 97 to confirm that this section does not apply to require a super fund to determine an untaxed element in relation to the payment of a death benefit superannuation lump sum (from a taxed fund) that is to be rolled over by an eligible dependant to commence a death benefit income stream.

The FSC's preferred option, modifying section 307-290, would provide a better outcome that eliminates the requirement (in the Government's proposal) for the sending fund to calculate an untaxed element that would then need to be excluded from assessable income by the receiving fund. The Government's proposal would create an additional untaxed element to track as part of a member's balance, increasing administration costs — these additional costs are in our view unnecessary.

Only a dependent can now rollover a death benefit and is restricted to only commence an income stream. So arguably there should be no mischief in adopting the FSC's preferred approach on the basis that the recipient is a dependant and is not cashing out the lump sum.

If however the approach in the draft legislation is maintained, then we would request further guidance on how this will affect fund administration and reporting, and whether the Government intends that any income stream payment from an untaxed element after rollover should be subject to tax.

3.2.1 Death benefit rollover interaction with tax offset

The FSC also has a concern with death benefit rollovers where the deceased was under 60 at the time of death and the beneficiary is under the age of 60 at the time the payment is received.

If the rollover amount relates to a taxed element, then a pension relating to that amount will be included in assessable income and the individual will receive a tax offset equal to 15% of the assessable amount. However, if the rollover relates to an untaxed element, a pension relating to the untaxed element will still be included in assessable income however they will not receive the 15% tax offset.

This implies that the beneficiaries in this latter case could be disadvantaged as a result of the rollover.

This issue should be addressed if the FSC's preferred solution modifying section 307-290 is implemented, as discussed in Section 3.2 above.

4 Regulation amendments

4.1 Fixing the valuation of defined benefit pensions under the transfer balance cap to reflect when pensions are permanently reduced

The FSC supports the intent of these amendments, which relate to Schedule 1, Part 1 of the exposure draft regulations, and notes that the scope has been broadened to include lifetime annuities.

For a reversionary lifetime annuity this means that if the original annuitant dies and annual payments are reduced the transfer balance amount credited to the reversionary will be adjusted for the lower payments. This aligns with the approach applied to lifetime pensions and defined benefit pension schemes.

This change is welcomed by the industry and will assist to ensure consumers with a variety of different pension products are treated consistently.

4.1.1 Issue with certain defined benefit arrangements

The proposed changes appear to still adversely impact members of certain DB arrangements in that they would appear to still be subject to an excess transfer balance for a period of time (based on the value of their initial annual entitlement) before the actual reduction in income stream payments occurs. This may require some members to remove other super monies from the retirement phase (such as an account based income stream if they have any) and be liable for excess transfer balance tax, despite the initial annual entitlement not being permanent.

As the variation in payments for these types of products often applies in cases where a spouse commences receiving a reversionary pension, it is important that this is dealt with appropriately so as not to financially prejudice these members.

Consideration should be given to amending the regulations to allow the special value of the income stream to be determined based on the anticipated reduced amount at the time the income stream is initially valued. Alternatively it may be appropriate to give the Commissioner the power to determine the appropriate credit value, or to waive any excess transfer balance that may arise, taking into consideration the client's circumstances.

In addition, similar to the point raised in Section 3.1.1 of this submission, as the proposed changes are effective from 1 July 2017, they will impact retirement phase events already reported for all applicable income stream products. As part of these amendments we would appreciate clarity on how the approach to reporting any amendments will be managed. This should ideally be facilitated by the ATO, with consideration of relief from any applicable reporting timeframes.

4.2 Maintaining the treatment of market-linked pensions under the transfer balance cap where they have been rolled over, or as a result of a successor fund transfer

The comments below relate to Schedule 1, Part 3 of the Exposure Draft regulations.

Under these proposed changes, where a transfer of a capped DB income stream occurs as part of a successor fund transfer (SFT), the new income stream will continue to be treated as a capped DB income stream in cases where the income stream is a lifetime pension (this was already the case); lifetime annuity; life expectancy complying term pension; annuity (known as 'life expectancy'); or market-linked pension.

The FSC supports the intent of these amendments and notes that the scope has been broadened to include lifetime annuities and life expectancy pensions and annuities, which is a welcome improvement.

This change will assist to ensure consumers with a variety of different pension products are treated consistently.

We do have comments regarding the circumstances in which the provision of transfer balance account reports is required.

4.2.1 Requirement to provide Transfer balance account report

In principle, we consider a SFT should not trigger a requirement to report to the ATO a retirement phase event or entry in the account of a super fund member given it is an involuntary transfer on the part of the member.

Instead, there has merely been a change of Trustee in respect of the Fund.

However, existing rules appear to create a retirement phase event when an SFT occurs.

We consider the existing rules should be amended so that a retirement phase event should not occur. However, if the retirement phase event does occur, then the debit and immediate credit ought to be the same value and therefore cancel each other out, resulting in no change to the member's TBA balance.

4.3 Changing the definition of life-expectancy period for innovative income stream products to account properly for leap years

The FSC supports the intent of these amendments, which relate to Schedule 1, Part 4 of the exposure draft regulations, and notes that this change is required for innovative income stream products to make use of new age pension means testing rules, which will commence on 1 July 2019. Compliance with the innovative income stream regulations is essential for products to be eligible for the new means testing rules, as non-compliance results in punitive means testing treatment for these products.

Unfortunately, the proposed changes do not adequately account for leap years. Leap years do not strictly occur every four years and have adjustment periods that occur.[2]

Instead of attempting to draft rules around the complexity of leap years, we submit the better drafting approach would be for the regulations to refer to ***the actual number of days*** in the life expectancy period.

There should be no concerns with this approach. Annuities are anniversary-based products and using the actual number of days will allow annuities to continue to operate on an anniversary basis, utilising the date of commencement/purchase. Any deviation from the actual number of days will create unexpected outcomes for holders of annuity products.

[2] See an explanation here: https://en.wikipedia.org/wiki/Leap_year