FINANCIAL SERVICES COUNCIL

General Manager
Personal and Retirement Income Division
The Treasury
Langton Crescent
PARKES ACT 2600

12 February 2013

Dear Sir / Madam

FSC Submission on death benefits regulations

The Financial Services Council (FSC) welcomes the opportunity to comment on the Treasury's draft regulation on to provide tax certainty to the beneficiaries of deceased estates.

The FSC represents Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks, private and public trustees. The FSC has over 130 members who are responsible for investing $1.8 trillion on behalf of more than 11 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. The FSC promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

The FSC strongly supports the Government's announcement in the October Mid-Year Economic and Fiscal Outlook for 2012-2013 that it would make regulations to allow the tax exemption for earnings on assets supporting superannuation pensions to continue following the death of a fund member in the pension phase until the deceased member's benefits have been paid out of the fund (the MYEFO death benefits measure).

When made, these regulations will ensure that the beneficiaries of a deceased member's estate do not inherit a tax liability, and also assists superannuation funds with the administration of the accounts of deceased members.

The FSC is concerned, however, that the commencement date of 1 July 2012 creates uncertainty as the ATO Draft Ruling TR 2011/D3, when made final, is expected to have effect from 1 July 2007. The FSC recommends that the regulations be made retrospective to align with the commencement date of the ruling.

Further, our understanding is that the MYEFO death benefits measure was intended to address the various administrative difficulties which aspects of the ATO's TR 2011/D3 would give rise to in relation to pension accounts of deceased members. However, it is not entirely clear that the draft regulations address all of the relevant administrative issues because it appears to focus solely on fund taxation and makes no mention of certain administrative benefits taxation considerations.

It is particularly important that the measure will have the effect that the tax components of any

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benefits paid after death would be calculated in isolation from any other accounts the member may hold in the fund, and would continue to be calculated based on the proportions of tax free and taxable component at the time the pension commenced.

In our view it is important that the measure extends beyond fund taxation considerations to benefits taxation, including the calculation of tax components for death benefits to achieve the appropriate outcome.

Tax administration if MYEFO death benefits measure does not address tax component issues

If the tax certainty arising from the MYEFO death benefits measure is limited to only solving the fund tax problem then, unless the pension automatically reverts on death, the fund could potentially be subject to:

- a requirement to treat the proportioning rule calculations for any benefits paid after the member's death in the same way as benefits paid from accumulation phase; and
- a requirement to aggregate the pension account and any accumulation account the member may hold in the fund for the purposes of calculating components of benefits paid from either account.

These requirements are likely to involve extensive manual intervention of large fund administration systems to override automated processes and calculations for the reasons outlined in the appendix to this letter.

In summary, limiting the measure to the fund tax issue would create extensive administrative difficulty in relation to benefit tax components. The resulting treatment would be inconsistent with typical administrative treatment of payments from both pension accounts and accumulation accounts by failing to fall within either category.

Instead, the FSC seeks confirmation that a deceased member's pension account should be treated for both fund tax and tax component / benefits tax purposes as continuing post death until the benefits have been paid from the fund.

Yours sincerely

BLAKE BRIGGS
SENIOR POLICY MANAGER

Administrative complexity arising from TR 2011/D3

Typically an administration system automatically calculates the tax components of benefits based on whether they are paid from accumulation or pension phase. If paid from pension phase, the tax component proportions are based on the proportions of tax free and taxable component at the time the pension commenced. If paid from accumulation phase the tax component proportions are based on the proportions of tax free and taxable component at the time of the payment having regard to (amongst other things) earnings received up until that time. Payment summaries for benefits showing the tax components are automatically generated on this basis.

If the tax components of a benefit paid from the pension account were to be calculated in the same fashion as an accumulation account from the time of death then the tax free component of the pension account would be required to be crystallised as a fixed dollar amount from the time of death. This would mean that any credits/debits/changes in value from that time until the time of a benefit payment would effectively add to, or reduce, the taxable component first. Calculations of the tax components of a post-death benefit would therefore require identification of the value of the member's account balance on the date of death and of all the transactions (eg interest, dividends, distribution, fees, benefit payments) since that time. Typically these calculations would need to be performed on a retrospective basis as the fund will not be notified of the relevant member's death until some time after death occurs. Further, if death benefits are paid out by instalments (which is common in the case of illiquid investments) then manual calculations would be required in respect of each instalment, taking into account any credits/debits/changes in value that occurred since the last payment.

The calculations would be further complicated if the deceased member had an accumulation account in the fund prior to death and the pension and accumulation accounts had to be aggregated for the purposes of calculating the tax free and taxable components of any benefits paid from either account under section 307-125 of ITAA97.

In addition to a greater time cost, with any manual calculations comes a greater risk of errors which could lead to:

- the need to delay or reissue payment summaries and associated ATO reporting with the corrected details;
- incorrect PAYG withholding amounts;
- incorrect anti-detriment calculations given that the size of the anti-detriment benefit is based on the size of the taxable component of a lump sum (using the formula method in ATO ID 2007/219); and
- an increase in the level of complaints from beneficiaries.

It is also worth noting that if the proposed measure does not also extend beyond the fund taxation aspect then it would appear that funds would have to re-characterise any post-death pension payments as lump sums for tax purposes (to the estate) in situations where the fund trustee does not find out about the death in time to stop further payments being made to the member's bank account. If funds had to re-characterise benefits in this way then not only would there be have incorrect tax components represented for benefit payments (which would have flow on impacts to the component calculations of future payments) and PAYG tax payments but funds would also have to issue lump sum payment summaries in place of income stream payment summaries and amend ATO reporting.