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24 October 2014

Manager
Contributions and Accumulations Unit
Personal and Retirement Income Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: ENCCTax@treasury.gov.au

Dear Sir

Subject: Reforming the Superannuation Excess Non-concessional Contributions Tax

Mercer is pleased to present its submission on the exposure draft.

Please contact myself or John Ward (03 9623 5552) if you have any queries in relation to our submission.

Yours sincerely

Dr David Knox

Senior Partner

MERCER

TALENT • HEALTH • RETIREMENT • INVESTMENTS

REFORMING THE SUPERANNUATION EXCESS NON-CONCESSIONAL CONTRIBUTIONS TAX

MERCER RESPONSE TO CONSULTATION PAPER

24 OCTOBER 2014

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1

EXECUTIVE SUMMARY

Mercer supports the general concept of providing an option which will enable members to avoid the payment of excess non-concessional contributions tax by arranging a refund of excess non-concessional contributions and associated earnings.

However we have significant concerns about the costs to superannuation funds and to fund members which will result from the legislation as currently drafted.

We acknowledge the determination of Associated Earnings has been simplified and will not involve funds in any calculation expense. However other aspects of the draft legislation appear to result in unnecessary costs and red tape (we have included some cost estimates in our submission). In particular:

1. The requirement for refunds to first come from the tax free component (TFC) will increase costs for superannuation providers and members, particularly where a member has a pension interest (refer to Section 2)

    Recommendation 1: Costs and red tape would be reduced by the adoption of one of the following three alternatives:

    (i) Remove any requirements for refunds to be first made from the TFC. (This is the simplest of the three alternatives)
    (ii) Require the refund to first be made from the TFC of any non-pension account. Where this is not sufficient the refund would be made from any balance of a non-pension account and then from any pension account (in which case the proportionate rule would apply). Specifying a required order will reduce the problems raised in point 2 below
    (iii) Maintain the requirement for refunds to be first made from the TFC but, in respect of income streams, override the existing proportioning rule to enable the required amount to be withdrawn solely by

commuting part or all of the TFC enabling the existing pension to continue based on a recalculated tax free proportion (this is a more complex alternative but still preferable to the approach in the exposure draft).

2. The effective requirement for product providers to contact members for whom they hold more than one superannuation interest to determine which interest should be used first will considerably increase costs and the time taken to process the refunds (refer to Section 3)

   Recommendation 2: Costs and red tape would be reduced by requiring the member to specify to the ATO (when making their refund election) the interest from which the refund should be made (or a priority order).

3. The requirement for the member to specify a superannuation provider rather than specify a particular fund will add considerable costs to superannuation providers who operate more than one superannuation fund, as well as being confusing for members (refer to Section 4)

   Recommendation 3: Costs and red tape would be reduced by requiring the member to specify to the ATO (when making their refund election) the particular fund AND interest from which the refund should be made (or a priority order).

4. The 7 day time frame given to superannuation providers to process refunds is insufficient to enable superannuation providers to complete the refund process – particularly based on the requirements as set out in the exposure draft (refer to Section 5)

   Recommendation 4: The time frame should be extended to a period of at least 60 days based on the requirements in the exposure draft. However the time frame could be reduced significantly if our recommendations 1, 2 and 3 are adopted. In that case 10 business days may be appropriate. We note a longer time period should be allowed in respect of refunds made during 2015 because funds will not have sufficient time to make the necessary systems changes.

5. The interest rate used to determine associated earnings will generally result in an amount significantly greater than the actual earnings on excess contributions and is therefore likely to result in ongoing criticism (refer to Section 6)

   Recommendation 5 A lower rate of interest should be adopted particularly in the first year of operation where it is likely there will be a need for significant delays in issuing assessment notices.

6. Requiring a product provider to certify they have obeyed the law appears to be purely red tape (refer to Section 7)

   Recommendation 6 - Red tape would be reduced by removing proposed section 96-35(1A)(b).

In Section 8 we have also set out a number of areas where improvements could be made to the Explanatory Memorandum.

Section 9 sets out Regulations we consider need to be amended to facilitate the introduction of the refund process.

2

TAX FREE COMPONENT – Pension issue

Proposed sections 96-20(1B) and 96-25(3) require refunds to be made firstly from the tax free component of each of the superannuation interests held by the superannuation provider:

a. These sections create significant difficulty where the member has a current pension interest because the tax free component (TFC) is a fixed percentage of each payment in relation to the pension.

b. Where a pension needs to be partially commuted to make the refund, due to the proportioning rule, it will be necessary to commute a much higher amount than the required refund so that there is sufficient TFC to make the refund. In some cases the whole pension may need to be commuted. The outcome will generally be the member having a significant amount of commuted pension which is not necessary for the refund.

c. We consider this outcome (and hence the requirement) is inappropriate because:

    i. It will lead to additional costs, paperwork and the need to liaise with the member. As part of the partial commutation to make the refund, the superannuation provider will need to communicate with the member and obtain member instructions in relation to:

        - Determining whether the remaining commuted value of the pension should be used to purchase a new pension (a new signed application form would be necessary)

- Determining whether any non-commuted amount of the original pension should also be commuted and combined in any new pension (commutation instructions and a new signed application form would be necessary)
- Determining whether any remaining commuted amount should be rolled over to an account in the growth phase (in some cases a new signed application form will be necessary)

We have estimated these additional costs (over and above the costs of making the refund) at in excess of $1,000 where a refund needs to be made from a pension account.

ii. There is a potential adverse impact on the member's eligibility for the age pension. (For example the member may become subject to deeming for age pension income test purposes because the new pension will not be eligible for grandfathering of the current deductible amount approach)

iii. The potential adverse impact for defined benefit pensioners where either the fund rules or the SIS Regulations may not enable a new defined benefit pension to be commenced

iv. Higher additional costs are likely where the member was unaware of the implications of electing the refund option, particularly as by the time the superannuation provider is aware of the existence of the release authority, the member will have already made an irrevocable election

RECOMMENDATION 1:

Costs and red tape would be reduced by the adoption of one of the following three alternatives:

(i) Remove any requirements for refunds to be first made from the TFC. (This is the simplest of the three alternatives)

(ii) Require the refund to first be made from the TFC of any non-pension account. Where this is not sufficient the refund would be made from any balance of a non-pension account and then from any pension account (in which case the proportionate rule would apply). Specifying a required order will reduce the problems raised in Section 3

(iii) Maintain the requirement for refunds to be first made from the TFC but, in respect of income streams, override the existing proportioning rule to enable the required amount to be withdrawn solely by commuting part or all of the TFC enabling the existing pension to continue based on a recalculated tax free proportion (this is a more complex alternative but still preferable to the approach in the exposure draft).

3

MULTIPLE INTEREST ISSUE

When electing the refund approach, proposed section 96-7(3) requires the member to specify one or more superannuation providers who hold/s a superannuation interest for the member. Even where the person is only a member of one fund, the member may have more than one interest in that fund.

It is unreasonable to expect the trustee to choose (even subject to the tax free component first rule) from which interest the refund will be made. The trustee may be subject to complaints and potential legal action if the refund has been made from a particular interest rather than another interest.

In many cases the trustee would need to contact the member to obtain proper instructions before making the refund payment however this is unlikely to be achievable bearing in mind the 7 day payment time frame and will significantly increase the costs of the process. We estimate these additional costs to be in the vicinity of $1000 for each member with multiple interests (including writing to and following up a response from the member).

> *RECOMMENDATION 2:*
>
> Costs and red tape would be reduced by requiring the member to specify to the ATO (when making their refund election) the interest from which the refund should be made (or a priority order). Amendments to proposed sections 96-7(3), 96-20 and 96-25 would be required.

4

MULTIPLE FUND ISSUE

As indicated above, when electing the refund approach, proposed section 96-7(3) requires the member to specify one or more superannuation providers who hold/s a superannuation interest for the member. We expect, in many cases the member will be unaware of who the provider is or will incorrectly specify the provider. We note this is different to the far preferable approach adopted in section 96-5(3) in relation to the refund of excess concessional contributions where the member is required to specify the superannuation interest which should be used (or the amount to be released from each if specifying more than one interest). It is also different to the approach adopted for release authorities relating to Division 293 tax where the member can specify the particular fund and interest when lodging their release authority.

Some superannuation providers operate more than one fund. It is possible some members are members of more than one of these funds. Providers would potentially need to check their membership records for each of their funds to determine which fund (or funds) the member belonged to. This will add to costs.

This is further complicated by the requirements of proposed section 96-20 and 96-25 which may require the payment to be split between interests in different funds of the same provider, complicating reporting and adding further to costs. Significant manual intervention is likely to be involved in this process – liaising with different administrators etc.

RECOMMENDATION3:

Costs and red tape would be reduced by requiring the member to specify to the ATO (when making their refund election) the particular fund AND interest from which the refund should be made (or a priority order). This would require amendments to proposed sections 96-7(3), 96-20 and 96-25.

5

TIMING

Proposed sections 96-20(1A), 96-25(2) and 96-42 set out time limits of 7 days for payment and reporting of the refund payments. Although such a time limit is consistent with the time limits in relation to the refund of excess concessional contributions we consider it is inappropriate for the following reasons:

a. It is inconsistent with the longer periods applicable to release authorities relating to the payment of Division 293 tax, excess concessional contributions tax and excess non-concessional contributions tax (all 30 days)

b. As drafted, the process involved for funds is far more complex and time consuming than for the payment of amounts under other release authorities (for example the need to find different interests in the same fund, the need to find different interests in other funds managed by the same provider, the need to pay firstly from the tax free component, the need to contact members to obtain instructions as to which interest should be used for the refund and complexities involved in co-ordinating different administrators (whether interests in two funds are involved) are complications not generally present in other situations)

c. By being expressed in days (rather than business days) it is unlikely funds will be able to comply when the seven day period incorporates a number of non-business days – in particular the Christmas and Easter periods

d. We expect release authorities issued in respect of the 2013-14 year will be received before funds have had time to implement the appropriate procedures and system changes. It is likely manual overrides will be necessary in many cases creating further delays in payment

e. Some of the 7 day period may be lost due to time delays in receiving the release authority by post, or in some cases because the release authority has been sent to the fund's tax agent rather than the fund

RECOMMENDATION 4:

The time frame should be extended to a period of at least 60 days based on the requirements in the exposure draft. However the time frame could be reduced significantly if our recommendations 1, 2 and 3 are adopted. In that case 10 business days may be appropriate. We note a longer time period should be allowed in respect of refunds made during 2015 because funds will not have sufficient time to make the necessary systems changes.

6

CALCULATION OF ASSOCIATED EARNINGS

We acknowledge the need for simplification in the determination of "associated earnings". Simplification has been achieved by using a "proxy" for associated earnings which is based on:

a. An assumption the excess contributions were made on the first day of the financial year
b. An assumption the earnings rate of the fund equals the average General Interest Charge (GIC) rate for the year which, for excess contributions in the 2013-14 year, results in a rate of 9.66% pa for the period 1 July 2013 to the date of the assessment

We also acknowledge that the proposed approach will result in a significant reduction in the "penalties" imposed in relation to excess non-concessional contributions.

Assumptions and approximations are necessary to avoid significant additional costs for superannuation funds. However the resultant amount of proxy earnings is likely to come under strong criticism as it will generally be far in excess of any earnings actually achieved on any excess contributions for the period they remain in the fund. Where excess contributions were only made late in the year, the associated earnings as proposed could equate to an actual implied earning rate of over 30% pa in respect of the period the excess contributions were actually in the fund.

The specification of the proxy return rate is also likely to be criticised as misleading due to it being compounded on a daily basis resulting in an effective rate of 10.14% pa.

Where the excess contributions have not been rolled over to a pension account, members will also expect a tax offset in relation to the tax on investment earnings paid by the fund.

RECOMMENDATION 5:
We accept the need for a proxy method; however, a lower rate of interest should be adopted particularly in the first year of operation where it is likely there will be a need for significant delays in issuing assessment notices

7

NOTIFICATION TO ATO

Proposed section 96-35(1A)(b) requires the superannuation provider to notify the Commissioner whether they have complied with Sections 96-20(1B) or 96-25(3). This appears to be red tape requiring the provider to advise the ATO they have complied with the law. As such it should be unnecessary.

RECOMMENDATION 6:

Proposed section 96-35(1A)(b) should be removed.

8

GREATER CLARITY NEEDED IN EXPLANATORY MEMORANDUM

The Explanatory Memorandum needs to be expanded to provide greater clarity in the following areas:

a. It would be useful if the Explanatory Memorandum clearly indicated a defined benefit lifetime pension was considered to be a defined benefit interest.

b. Example 1.3 needs to be expanded to explicitly indicate (where a partial refund has been made) that the amount refunded will first offset the excess non-concessional contributions (rather than the associated earnings)

c. Example 1.3 needs to be expanded to cover the situation where Archibald has an additional accumulation interest held by a different provider. The example should indicate whether on being advised the original fund has only made a partial payment:
   i. Archibald must then specify the other fund and obtain the balance of the refund from that fund; or
   ii. If Archibald does not so specify, whether the ATO will use its powers to request a refund from the other fund; or
   iii. If Archibald does not so specify, Archibald will be subject to excess non-concessional contributions tax on the remaining excess and all associated earnings can remain in the fund

d. A variation of Example 3 needs to be provided where the fund was able to refund all the excess non-concessional contributions but only part of the associated earnings. This will be particularly relevant where the person has an accumulation interest in another fund. Similarly to point b above:

   i. Must the person then specify the other fund and obtain the balance of the refund from that fund; or
   ii. If the person does not so specify, whether the ATO will use its powers to request a refund from the other fund; or
   iii. If the person does not so specify, the person will NOT be subject to excess non-concessional contributions tax on the remaining excess and the unrefunded associated earnings can remain in the fund

e. Subsection 96-25 relates to voluntary release of monies from DB interests. However it does not appear to cater for situations where:

   i. the make-up of the DB interest is such that the provider is not willing or able to release the maximum available release amount but is willing to release a lower amount which is also lower than the the amount stated in the release authority – is the only option to release nil in this instance?
   ii. There is more than one DB interest with a TFC and the provider is willing to release an amount from only one of the DB interests and the TFC of that interest is less than the amount stated in the release authority

The issues raised above could be addressed by clarifying comments in the Explanatory Memorandum.

9

CHANGES NEEDED TO REGULATIONS

We recommend consideration be given to making the following amendments to regulations to better enable the operation of the new provisions:

- Amending or, preferably, deleting SIS Regulation 1.08 to enable the commutation of defined benefit pensions on a realistic basis without the need to apply to APRA for approval. SIS Regulation 1.08 was part of the Reasonable Benefit Limits regime and should have been deleted when that regime was abolished in 2007. Its retention has simply retained red tape that no longer serves any useful purpose.

- Removing or amending the fund capped contribution requirements (SIS Reg 7.04(3)) to enable funds to accept transfer amounts from overseas funds which exceed the fund capped contribution limit.

Appendix A

Who is Mercer?

Mercer is a global consulting leader in talent, health, retirement and investments. Mercer helps clients around the world advance the health, wealth and performance of their most vital asset – their people.

Mercer also provides customised administration, technology and total benefits outsourcing solutions to a large number of employer clients and superannuation funds (including industry funds, master trusts and employer sponsored superannuation funds). We have $55 billion in funds under administration locally and provide services to over 1.3 million super members and 15,000 private clients. Our own master trust, the Mercer Super Trust, has over 240 participating employers, 226,000 members and more than $18 billion in assets under management.

Our trustee company, Mercer Superannuation Australia Limited is the trustee of three superannuation funds.

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