22/10/2014

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

Email: ENCCTax@treasury.gov.au

Dear Madam/Sir,

SPAA SUBMISSION ON REFUNDING OF REFORMING THE SUPERANNUATION EXCESS NON-CONCESSIONAL CONTRIBUTIONS TAX

The SMSF Professionals' Association of Australia (SPAA) welcomes the opportunity to make a submission in relation to Treasury's exposure draft legislation and explanatory memorandum which implements the Government's intention to have fairer taxation of excess non-concessional contributions (NCCs).

SPAA supports the approach taken in the draft legislation which allows taxpayers to withdraw NCCs that exceed the NCC contribution cap with any associated earnings that are required to be withdrawn from the fund determined via a proxy rate. We believe that using the General Interest Charge (GIC) as a proxy rate to determine the associated earnings of an excess NCC is an appropriate mechanism that strikes an appropriate balance between simple tax laws and ensuring a fair outcome for taxpayers. While having earnings deemed at the rate of the GIC may still seem punitive to some taxpayers, we believe that it is an appropriate disincentive to exceeding the NCC cap while also providing a fairer outcome for taxpayers than the existing tax treatment of excess NCC.

There are also a number of technical issues with the legislation that we have highlighted in the attachment. However, we are supportive of the draft legislation and the proposed amendments.

About SPAA

SPAA is the peak professional body representing the self managed superannuation fund (SMSF) sector throughout Australia. SPAA represents professionals, irrespective of their personal membership and professional affiliations, who provide advice to individuals aspiring to higher levels of participation in the management of their superannuation savings. Membership of SPAA is principally accountants, auditors, lawyers, financial planners and other professionals such as actuaries.

If you have any queries about our submission please do not hesitated in contacting us.

Yours sincerely,

Andrea Slattery

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Withdrawing excess non-concessional contributions

SPAA supports the proposed amendments that allow a taxpayer who has made NCCs which exceed the NCC cap to withdraw the excess NCC, rather than the excess NCC being taxed at the top marginal tax rate. We believe that this will result in a more just treatment for taxpayers that have inadvertently breached the NCC cap than under the current NCC excess contributions tax treatment.

The mechanism embodied by the draft legislation is simple and efficient in allowing taxpayers to withdraw excess NCCs once the Commissioner of Taxation has issued them with an excess contributions determination.

Withdrawing associated earnings

We support the draft legislation's proposed proxy rate method for calculating earnings associated with the excess NCC. We believe that using a proxy rate to determine associated earnings is a much simpler and cost-effective solution which reduces red-tape for superannuation funds and their members.

Further, the deemed earnings rate approach allows the Commissioner of Taxation to issue the taxpayer with a determination of the amount that must be withdrawn from their superannuation fund as associated earnings. We endorse this aspect of the excess NCC refunding mechanism as it reduces the compliance burden and risk of incorrect self-assessment for the taxpayer.

Also, we support the General Interest Charge rate (GIC) as an appropriate proxy rate. The GIC changes in line with interest rate levels, which provides a conservative base line return for superannuation fund returns to be judged against. The uplift factor in the GIC (7 percent above the 90 day bank bill rate) acts as an appropriate disincentive for taxpayers not to exceed the NCC cap. In years where the GIC does not appropriately reflect superannuation fund returns, the power for the Minister to alter the proxy rate in item 31 of the draft legislation will resolve this issue.

Alternative proposals to allow superannuation funds to have an option to calculate their actual earning rate would increase the complexity of the tax law, resulting in increased compliance for superannuation funds. The increase in compliance would have occurred as superannuation funds (both APRA-regulated funds and SMSFs) would calculate actual earnings as well as the deemed approach to see which method would yield a better result for their members. This is a common behavioural effect caused by tax law which allows taxpayers an option on how to calculate an element that affects their final tax liability. The deeming approach avoids this problem.

The alternative approach which has been suggested is to only tax earnings on excess NCCs based on the fund's actual earnings rate. This method involves tracing the particular NCC paid into the fund (which corresponds to the excess NCC) and determining the actual rate of return that that particular amount of money has earned. Whilst this process is complex enough, various amounts of the excess NCC may relate to different fund investments and have differing rates of return which will make calculating the actual total earning rate more difficult.

We understand that this proposal may involve the member calculating the fund's actual earnings and then having this amount verified/confirmed by a professional such as an accountant or tax agent. This additional step of verification adds a further unnecessary layer of cost, uncertainty, complexity and difficulty for the member. This is especially relevant where an SMSF trustee self-assesses and self-lodges their SMSF's annual tax return. In consideration of the Australian tax system being a self-assessment based system, taxpayers should be able to self-assess their tax liabilities without the mandated engagement of a taxation professional.

In addition, there will be times when the taxpayer and/or the professional may inadvertently get the calculations wrong. This may lead to the imposition of penalties which could have been avoided if this method were not adopted to begin with. It may also increase professional indemnity claims against the professional who provides the verification of the fund's actual earnings despite using best endeavours to calculate this amount.

Unlike with the proxy rate, there will also be complexities in determining what date the relevant amounts become payable as earnings on excess contributions. The proxy option takes this additional complexity away.

SPAA is also concerned that the proposal to use the actual earnings rate will create unwanted behaviour by some who will seek to minimise tax payable by exploiting the excess NCCs. Due to the time-lag between making a contribution, the reporting of the contribution and issuing an assessment, members may use this deferral period to reduce tax payable by exploiting the low-tax superannuation environment. Similarly, taxpayers may be able to engineer returns in their funds that correspond to an excess NCC to limit the penalty for making excess NCCs. This will impact upon the integrity of the tax and superannuation systems.

Finally, we note that the number of excess NCC assessments issued by the ATO is small. As of 31 March 2014, for the 2011-12 income year there were 1068 excess NCC assessments, and for the 2012-13 year, only 49 assessments had been issued for excess NCCs and 55 for both excess NCCs and CCs.[1] SPAA contends that it would be unnecessary to introduce such a complex system for dealing with excess NCCs for such a small number of fund members.

Time requirements: 7-day and 60-day rules

SPAA is concerned that the 7-day time frame proposed in the draft legislation for superannuation funds to respond to a release authority issued under the proposed section 96-12 is too short. We believe that this timeframe is too short for superannuation funds to act on the release authority in a well-organised manner, especially as the 7 day time requirement:

- begins from the time the release authority is issued; and
- the 7 days are calendar days not business days.

Also, the 7 days requirement does not provide a superannuation fund with adequate time to sell assets to generate cash required to refund a taxpayer's excess NCC. This is especially the case where a fund has a high proportion of its assets invested in illiquid investments.

SPAA recommends that Treasury reconsider the 7-day time limit and provide a more reasonable time limit, possibly 28-days, for superannuation funds to respond to a release authority issued by the Commissioner. This would allow for a more orderly response, including greater time for funds to realise assets.

We realise that the 7 day time limit to respond to the release authority is consistent with that allowed under the excess concessional contribution refunding scheme. However, we do not believe that consistency should be maintained where it will result in increased compliance difficulties for superannuation funds.

The 60 day time limit for taxpayers to respond to an excess NCC determination is adequate for taxpayers to be able to make an election as to whether they want their excess NCCs

[1] see the ATO Research and Statistics, https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/General-statistics/Excess-contributions-tax-statistical-report/?page=2

refunded. We support the discretion for the Commissioner to be able to extend the period for the election where the taxpayer's circumstances require further time.

SMSF notification of release

Item 27 of the draft legislation (draft section 96-42) requires a superannuation provider to notify a fund member when a successful release is made in accordance with a release authority issued under section 96-12. Given that members of SMSFs are generally the SMSF's trustees, we do not believe that this requirement is necessary for SMSF trustees. Accordingly, we recommend that SMSF trustees be carved out of the application of draft section 96-42.

Superannuation Industry (Supervision) Regulations 1994 condition of release

We note that paragraph 1.37 of the draft explanatory memorandum recognises the need to amend the Superannuation Industry (Supervision) Regulations 1994 (SISR) so that a release authority for refunding excess NCCs is a condition of release. We would encourage the Government to make the required SISR change simultaneously with the passage of the taxation provisions. Otherwise, the refunding mechanism for NCCs will be ineffectual as superannuation funds will not be able to release the excess NCCs and associated earnings without contravening the SISR. This would result in the released amount being viewed as an early release amount and taxed at the taxpayer's marginal tax rate under Division 304 of the *Income Tax Assessment Act 1997* (ITAA 1997).

Compulsory release of excess NCC and associated earnings

Where a taxpayer receives an excess NCC determination and elects for their fund to release the excess NCC and associated earnings, the draft legislation makes it compulsory for the fund to release the required amount unless the member's superannuation interest is nil or the member is a defined benefit member. We believe this will cause problems where a superannuation fund has frozen or illiquid assets and are not able to release the required cash amount. The fund will be liable for a $3400 penalty (20 penalty units) where they do not comply with the release authority.

It may be appropriate for the Commissioner to exercise discretion under his general power of administration to allow a fund further time to comply with a release authority where it cannot comply with the authority because it has significant illiquid or frozen investments. We believe a comment to this effect in the explanatory memorandum would give taxpayers confidence in the law and will also be useful guidance for the Commissioner.

Effect on pension interests

Draft subsection 96-20(1B) requires released amounts to be paid from the tax-free component of a superannuation fund first, and the taxable component second. For members that have a superannuation interest which is in pension phase, subsection 307-125(3) of the ITAA 1997 requires that the tax-free and taxable components be calculated at the commencement of the superannuation income stream. The tax-free and taxable proportions determined at this time set the proportions for ensuing income stream payments. Paying a release amount under draft subsection 96-20(1B) from the tax-fee component first will not alter future income stream payments' tax-free and taxable proportions.

We do not think that this result achieves the policy intent of requiring the released amount to be paid from the tax-free component first. Further, it also provides an incentive for taxpayers with large excess NCCs to commence a pension prior to a refunding of excess NCCs occurring.

We believe that an appropriate solution is for the components to be reset just before and after the release is made. This would require the following to occur:

1. The value of the tax-free and taxable components to be calculated as if the interest supporting the income stream was to be paid out as a lump sum (i.e. a full commutation) just before the release is made.
2. Then the value of the tax-free amount of the interest is to be reduced by the released amount.
3. Then the tax-free and taxable components of the superannuation interest are to be adjusted for the reduction of the tax-free component caused by the release.
4. Future pension payments take on the new tax-free and taxable proportions.

We realise that this approach may add additional complexity to the proposed law but believe that it will maintain integrity and deliver an appropriate policy outcome.

Interaction with transfers of UK pension entitlements

SPAA believes that the proposed legislation will have problematic interactions with UK pension transfers to Australian superannuation funds that are Qualifying Recognised Overseas Pension Scheme (QROPS) funds. UK pension transfers count towards a taxpayer's NCC cap. Where a UK pension transfer exceeds the NCC cap (either in addition to other NCCs or by itself), the draft legislation will cause a proportion of the UK pension transfer to be refunded to the taxpayer. This is likely to also occur even where the excess NCC is not from a UK pension transfer as UK tax rules recognise payments made from a QROPS fund to be made from the UK transferred amount first for reporting purposes.

This will likely trigger UK tax provisions, causing the released amount to be taxable in the UK. We believe that this result defeats the policy intent of both the NCC refunding mechanism and the QROPS scheme.

SPAA believes that it may be an appropriate solution to exclude UK QROPS transfers from the NCC cap so that this interaction is avoided.

Triggering of the bring forward rule

SPAA members have expressed concern that the refunding of excess NCCs only applies once the three year bring forward rule is triggered. This means that taxpayers who inadvertently breach their single year NCC cap cannot refund their excess NCC for the relevant year and will trigger their bring forward cap. This can result in taxpayers not being able to maximise NCC strategies going forward.

For example, a taxpayer makes $181,000 of NCCs in 2014-15. This triggers the bring forward rule for 2014-15, 2015-16 and 2016-17 financial years, limiting them to a further $359,000 NCCs for 2015-16 and 2016-17 financial years. If the taxpayer was expecting a $500,000 windfall in 2015-16 and intended on contributing it to their superannuation, under the current rules it will not be possible. However, if they could refund their excess $1000 NCCs in 2014-15, they will still be able to utilise the bring forward rule to maximise contributions in years to come.

This situation can be avoided by requiring an election by the taxpayer to use the bring forward rule for NCCs where they make contributions in excess of the NCC. If a taxpayer does not make the election, they would receive an excess NCC determination and be able to withdraw the excess from their fund.

While this may beyond the scope of the current measure, we believe that the Government should consider this amendment, especially in light of taxpayers being able to refund mistaken excess NCCs.