8 June 2012

Ms Christine Barron
General Manager
Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: cgt_super_roll-over@treasury.gov.au

Dear Ms Barron

Submission on Taxation Relief to support the implementation of Stronger Super

The FSC welcomes the Proposals Paper and the reaffirmation from the government that it continues to support the consolidation in the superannuation industry by allowing further loss rollover relief between merging superannuation funds.

We also welcome the initiative by Treasury to address loss rollover and member equity issues that may arise due to compliance requirements of the MySuper legislation.

The Financial Services Council (*FSC*) represents Australia's retail and wholesale funds management businesses, superannuation funds, life insurers and financial advisory networks. The FSC has 128 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 Stock 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.

In the interests of ensuring that the envisaged structural changes can proceed without impact on members or their benefit entitlements, the FSC wishes to comment on a number of aspects of the paper as well as raising for consideration some taxation issues which are not canvassed therein nor have they been previously addressed in government/Treasury releases.

Our comments are included below.

Yours sincerely

MARTIN CODINA
Director of Policy

Section 4.1.3 Certain realised losses will not be able to be transferred

Sections 4.1.3 and 4.2.2 of the Proposals Paper proposes an integrity provision pursuant to which a realised loss will not be able to be transferred if, in the twelve months prior to a merger, a superannuation entity disposes of an asset at a loss to the entity it is merging with (including a PST or life insurance company) and the transferor merger entity is still holding the asset on the date of the merger.

The FSC submits that it should be possible for a superannuation entity to treat all assets acquired from other superannuation entities pursuant to a fund merger as acquisitions at the market value of the asset at the date of the transfer. Further, the FSC submits that the transferor should recognise any asset transfer as a disposal and realisation of any gains and losses arising in respect of such assets. In the event that a net realised loss is incurred by the transferee, such losses should be capable of being transferred to the transferor as “realised losses”.

A large number of successor fund transfers are effected via "in-specie transfers". Many of these are effected through a transition manager, the reasoning being to align the asset holdings post-transfer with those that conform to the transferee's mandate. Accordingly, the transition manager will dispose of some assets, acquire some assets, and retain some assets of the transferor. The decisions to sell, buy or hold assets are made from the perspective of the recipient superannuation entity to ensure that the post-transfer asset mix meets the investment mandate and philosophy of the continuing entity. As such, the “hold” decision simply reflects those assets previously held by the transferor that the transferee would go to market and acquire in the absence of the “in-specie” transfer.

The FSC submits that the ability to transfer net realised losses from a transferor superannuation entity to a recipient superannuation entity should be retained in these circumstances and we note the following to this end:

- An overarching purpose of the provisions is to ensure the maintenance of member benefits pre- and post-transfer. Many custodians either cannot, or charge an additional fee, for the take on of data other than via a direct purchase (i.e. with original acquisition date, cost base, and tax-deferred distribution history). This additional fee would be on-charged to the transferring members with a reduction in their benefit value.

- An in-specie transfer avoids many transactional costs, such as "buy/sell spreads" (which might apply if a transfer of units in a unit trust is transacted as an application and redemption), stamp duty, and brokerage. If the integrity provisions, coupled with the inability of custodians to process transferred data, were to mean that the only means of protecting existing losses was to transact via an on-market disposal, these additional transactional costs would be incurred, and would be effectively borne by the members via these expenses reducing fund assets and therefore member benefits.

- Some assets of a transferor superannuation entity may be “frozen” or “distressed” and may therefore not be capable of being effected by an on-market transaction. For example, a unit trust might have its redemptions “frozen” by virtue of the fact that its assets are illiquid. Accordingly, the transfer of these assets to the continuing entity is effectively forced upon the recipient fund, rather than forming part of the transferee’s ordinary “hold” decision.

Whilst we appreciate the intention of the integrity measure to ensure that, as far as possible, losses are not utilised before a true "disposal" of an asset backing superannuation entitlements, we believe that the proposed measure does not necessarily achieve these objectives. Specifically, we understand that a common current position amongst superannuation funds is for those funds to have realised capital losses, and unrealised capital gains.

Accordingly, the proposed integrity measure might result in a greater amount of realised capital losses being transferred than would be the case if the relief permitted transferred of a realised net position. For example, assume that a superannuation fund had realised capital losses of $100 million and unrealised net capital gains of $60 million (made up of unrealised gains of $100 million and unrealised losses of $40 million).

The integrity measure as it is currently proposed would result in a successor fund "receiving" a transfer of $100 million of realised capital losses and a "rollover" of a net unrealised position of $60 million of gains. If the transferor was permitted to treat all assets acquired from other superannuation entities pursuant to a fund merger as acquisitions at the market value of the asset at the date of the transfer, then it would "receive" a transfer of a net realised loss of $40 million only.

We also submit that the perceived ability to generate a realised loss at a point in time earlier than would otherwise have been available to the transferor entity will not practically result in a significant benefit in terms of loss utilisation. The quantum of realised losses in ongoing funds is significant, and the larger combined fund creates a larger base of assets on which capital gains may accrue in future to recoup existing capital losses. Further, the realisation of assets of the closing funds will reset the cost bases of those assets for the ongoing fund (in loss circumstances, at a lower cost). The combination of these factors means that the timeframe in which the ongoing fund will recoup capital losses, and thus recommence paying tax on capital gains, is unlikely to be affected to any significant extent by the bringing forward of the unrealised capital losses in the closing fund.

Accordingly, we submit that an integrity measure which simply seeks to deny the ability to transfer realised capital losses when a transition is effected via "in-specie" asset transfers is inappropriate. Such an integrity measure is unnecessary when any such transition is performed with all assets (encompassing all unrealised and realised gains and losses) being treated as disposed by the transferor and the transferee only receiving a transfer of any net realised capital loss.

Section 4.1.5 Conditions for the asset rollover

The Proposal Paper states that "Mergers that have a completion time of 1 July 2017 will be accommodated in relation to the condition that requires mergers to take place within a single year".

For reasons of history, a number of superannuation providers have multiple fund divisions with complex rules and structures attaching to each. Suffice it to say that they are, in many ways, too complex to transfer other than on a staged basis – e.g. one membership division at a time. The "one year" rule for rollover relief has previously been seen as a further barrier to rationalising and modernising the superannuation arrangements of those funds' members via a successor fund transfer.

The FSC is interpreting the paragraph quoted above from the Proposals Paper as providing a window to 2017 which is to be treated as a "single year". If this interpretation is correct we would be wholly supportive. If not, we submit to Treasury that such an outcome would be beneficial in facilitating what could probably not otherwise be achieved within a limited timeframe of one year.

The FSC would see membership divisions as the basic unit for a one year test provided that there was a definite intention of the ceding Trustee that the whole of the fund be the subject of an SFT. Loss/rollover relief could then be addressed in an orderly (and logical) manner as each membership division was transferred.

MySuper transfers – preferred MySuper product in different fund

Tax relief under the transfer of default accounts to a MySuper product is not available where the current super fund offers a MySuper product. This is presumably because it is assumed the transfer of member balances to MySuper would be achieved via an intra-fund transfer. However this does consider the situation where the preferred MySuper product is offered by a different superannuation fund. This situation could occur where:

- the current super fund is no longer listed as a default fund under the Fair Work laws and the employer must choose another super fund offering a MySuper product.
- the MySuper product offered by a different super fund is viewed by the employer as superior to the MySuper product offered by the existing default super fund e.g. lower fees, broader insurance cover, etc.
- on consolidation of two or more staff funds into one superannuation fund, where both funds currently offer a MySuper product. It is likely the membership would be consolidated into one of the existing super funds, but tax relief would not be available for those members having to transfer to the other superannuation fund involved.

Example

Large Employer Pty Ltd has over 500 employees and currently uses XYZ super fund as the default fund for its employees.

In August 2013, Large Employer Pty Ltd decides to negotiate with several default super funds, including XYZ super fund, to tailor a MySuper product specifically for its employees. After assessing various super offerings, Large Employer Pty Ltd decides to choose the MySuper product within UVW Super Fund as its default fund from 1 October 2013.

Employees of Large Employer Pty Ltd have their SG contributions made into UVW MySuper product from that date, however they still have balances in XYZ super fund. These balances cannot be consolidated via transfer to UVW MySuper without incurring capital gains tax. This is because the proposed tax relief is not available where the former default fund, XYZ super fund, offers a MySuper product.

The FSC recommends that the tax relief be extended to include the transfers of assets as part of the transfer of existing default members to any MySuper product regardless of whether a MySuper product is offered by the existing fund.

Life Companies and PST's

The MySuper legislation will require superannuation funds to offer a MySuper compliant product by 1 July 2013 including for existing members who have not selected a choice of fund.

By 1 July 2017 all members who have not selected a choice of fund must have their assets transferred to a MySuper compliant product.

The Proposals Paper envisages the use of rollover provisions for two scenarios. Firstly, a scenario where there is a merger of two superannuation funds and a second scenario for superannuation funds which must now comply with the MySuper rules. Both scenarios also provide for optional relief for capital gains where the superannuation fund is eligible for the proposed loss rollover relief.

The FSC welcomes this relief under both scenarios.

Third scenario – Master Life Policies

The Proposals Paper however, does not appear to contemplate a third scenario, being the impact of the MySuper reforms for superannuation members of funds that offer tax investment structures such as Master Life Policy and Pooled Superannuation Trusts (PST).. Life insurance companies establish separate segregated asset pools to invest premiums under Master Life Policies which represent the superannuation contributions received from fund members. These assets pools are known as the complying superannuation/FHSA asset class ("VPST class") of the Life Company.

Many organisations offer multiple products within a single superannuation fund that invest through a life insurance company and/or PST. Further, these same superannuation funds may also offer products that have a direct (i.e. non-policy based) investment structure or PST. The multiple forms of investment may reflect the pooling of funds from different sources that have arisen historically which are directed at achieving the most efficient investment structure and a more streamlined administrative system while at the same time recognising that many existing arrangements have to be accommodated. The purpose of such multiple arrangements has been cost minimisation which ultimately benefits the members in these products. It further enables efficient and effective services to be provided to members by, over time, reducing the complexities in back office processes.

The FSC considers that this outcome is consistent with the objectives of the Government's Stronger Super reforms and movement towards a direct investing model is an option favoured by the industry for future superannuation products.

In the third scenario a superannuation fund may seek to create a MySuper compliant product division with a direct investing structure. The existing superannuation products may be currently invested through a life insurance company structure and/or PST. Where members (who have not selected choice of fund) of the existing products are transferred into the MySuper compliant product, the loss rollover rules as currently suggested in the Proposal Paper would not provide relief for members. The assets will move from the life insurance company or PST to the superannuation fund or to a PST, with members remaining in the same superannuation fund, albeit in a different product. See Diagram A attached. In this instance the compliance obligation of transferring members into a MySuper compliant product will detrimentally affect the member should the loss rollover provisions not be available.

Recommendation

The FSC recommends that the third scenario explained above and shown in Diagram A be considered by Treasury. The objective of MySuper is to provide a product offering that is in the best financial interests of members. In order to do this the FSC believes that the loss rollover provisions should be drafted to ensure that members are not inadvertently disadvantaged due to the historical investment structure of the superannuation fund.

The FSC recommends that for the policy intent of MySuper to be achieved, the loss rollover relief should be also provided where member assets are moved between the complying superannuation/FHSA asset class of the life insurance company or PST and a complying superannuation fund or PST, where the member does not move to another superannuation fund. We see scenario three as a natural extension of the previous loss rollover relief, in that it recognises life insurance company and PST structures, albeit this time through the lens of MySuper implementation.

Other taxation issues impacting members

Section 290-170 and MySuper Migrations

In the interests of protecting members, the FSC would like to ensure that members migrated under MySuper have the same rights as those migrated under an SFT. In particular, Section 290-170(5) of the Income Tax Assessment act 1997 should be expanded to explicitly include MySuper migrations.

Exclusion from "qualified person" requirements/ 45 day holding period rule

In the interest of protecting members, the FSC submits that merging superannuation entities be excluded from the qualified person requirements for the purposes of section 207-145 and section 207-150, ITAA 1997.

A superannuation entity merger will usually involve the transfer of assets held by the transferring entity to the successor fund. In the case where a share is held by the transferring fund at the point of being ex-dividend, and the related dividend is paid post-merger to the successor fund, the holding period rule ("45 day rule") contained in the qualified person provisions under section 160APHO of the former Part IIIAA, ITAA 1936 may not be satisfied.

Accordingly, Subdivision 207-F, ITAA 1997 may apply to deny the franking credits on the basis that the superannuation entity is not a qualified person in relation to the dividend received. Note that this assumes that the relevant entities have not made an election to have a franking credit ceiling applied in accordance with section 160APHR, ITAA 1936.

Therefore we recommend that merging superannuation entities that have not made a ceiling election in accordance with section 160APHR should be relieved from compliance with the 45 day rule for assets transferred as a result of a merger. As an integrity measure, this exclusion could be limited to a specified period of time post-merger.

As an alternative, the rules could be amended to ensure that the merger is not considered a disposal or an acquisition for the purposes of these rules.

Superannuation benefits payments

The FSC submits that for the avoidance of doubt, member benefits transferred in the event of a superannuation entity merger be specifically excluded from being Superannuation Benefits for the purposes of section 307-5, ITAA 1997 on the basis that the payments are not paid to the member or at their direction or request.

On a superannuation fund merger, all assets and members will be transferred to the successor fund. Ideally, all member account balances including all underlying tax component history should also be transferred as if the member had always been a member of the successor fund. This is to ensure that the member is not disadvantaged by the successor fund transfer and to preserve the member's entitlements.

A transfer of a member's balance to a successor fund may be interpreted under subsection 307-15(2), ITAA 1997 as being a "payment" made for the member's benefit and therefore considered a Superannuation Benefit under section 307-5.

If the transfer of a benefit under a merger arrangement is to be considered a Superannuation Benefit, a crystallisation calculation of the member's tax components is required. In periods of negative investment returns, the tax-free component can be inadvertently reduced. This may arise when there is no taxable component and accumulated investment earnings are less than the tax-free component of the member's interest. The member can be disadvantaged in this instance as their tax-free component becomes crystallised at the lower amount (reduced by negative investment earnings) yet their future investment earnings in the successor fund will be treated as the taxable component. This clearly results in an unfair outcome for the affected members.

This is of particular concern in the context of recent market conditions whereby temporary investment losses coinciding with a superannuation entity merger transactions may result in members suffering additional tax when they are paid their benefit.

A secondary related issue is that a requirement to calculate tax components would impose additional administration upon funds increasing compliance costs. Cost efficiencies arising out of the merger activity such as reduced member administration fees will be adversely impacted which is contrary to the intent of the MySuper reforms generally.

Therefore, the FSC recommends that clarification be provided within the law to ensure that benefits transferred under merger arrangements are not captured as Superannuation Benefits.

No-TFN contribution offsets (Section 295-675 of the ITAA 1997)

No-Tax File Number ("no-TFN") contribution tax arises where a member fails to quote their TFN to the superannuation fund.

A superannuation fund may be entitled to a tax offset for no-TFN contributions tax if the member later quotes their TFN. However, this entitlement is not transferable if the member changes superannuation funds.

As a recipient fund is not entitled to a tax offset on the no-TFN contribution income, we recommend that the law be amended to allow the recipient fund to obtain a no-TFN offset for a member who still has a superannuation interest with the successor fund and subsequently provides the fund with a valid TFN.

MySuper Asset Rollovers

We note that Treasury has proposed in section 4.1.6 that relief will be provided for asset rollovers for capital assets and revenue assets, in accordance with the previous rollover relief. A similar proposal has not be specified for transfers due to MySuper requirements as section

4.2.1 only refers to assets acquiring cost base details resulting in capital gains or losses being disregarded.

The FSC recommends that for the avoidance of doubt, the asset rollover relief due to MySuper requirements be aligned with relief provided for merging superannuation funds, by explicitly stating that it applies to both capital assets and revenue assets.

Timing

The FSC notes that the previous concession for CGT mergers expired on 1 October 2011 but that the Stronger Super provisions will not have effect until 1 July 2012. This leaves a nine month period where fund mergers will not receive any relief. It is likely that a small number of mergers which missed the 1 October 2011 deadline will receive no relief, despite having continued with their process in good faith and in the spirit of the MySuper changes.

We propose that either relief be backdated to 1 October 2011, or that relief is available to funds completing in this period on a case-by-case basis.

Conclusion

The FSC appreciates the consultative approach being adopted to ensure that the changes being brought into play in strengthening and improving the superannuation system do not result in unintended consequences to superannuation providers and their members.

We would welcome the opportunity to expand on any of the matters raised above and also to assist in reviewing draft legislation when it becomes available.

Diagram A – Scenario 3 (Life companies and PST's)