18 June 2021

Director
Retirement Income Policy Division
Treasury
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Email: superannuation@treasury.gov.au

Dear Madam/Sir

Consultation: Reducing Red tape for superannuation funds – ECPI measures

The Actuaries institute (the "Institute") welcomes the opportunity to comment on the draft legislation for the above measures. The Institute is the sole professional body for actuaries in Australia. Our members have had significant involvement in the development and management of superannuation within Australia. In particular, the prescribed actuarial role in certifying certain tax calculations for superannuation funds claiming exempt current pension income ("ECPI") gives actuaries a unique insight on how the proposed changes are likely to impact the sector.

The Institute is supportive of measures such as these that are aimed at simplifying reporting for superannuation funds and streamlining administration. We believe that the measure to exempt funds that are solely in retirement phase for an entire income year from the disregarded small fund asset provisions will reduce red tape. For the small number of funds that meet the definition of having disregarded small fund assets while also being solely in retirement phase for an entire income year it removes the unnecessary requirement to obtain an actuarial certificate to claim ECPI.

However, we are concerned that the draft legislation to affect the proposal to offer funds the choice of which method to use to claim ECPI during periods when the fund was solely in retirement phase is likely to achieve the opposite of what the proposal intended. Providing superannuation funds with far more options for how they calculate their tax liabilities will increase complexity and administration costs. In addition, allowing funds to optimise their tax outcomes in this way will inevitably reduce tax revenue.

We are also concerned that the measures are likely to be retrospective, in that they are not likely to be legislated until after 1 July 2021 but are slated to take effect for the 2021-22 income year.

We recommend that:

- Rather than adding new provisions to allow funds to choose which ECPI method to use, the existing legislation should be amended to clarify that funds are only deemed to have segregated current pension assets when they are solely in retirement phase for the entire income year. Funds would retain the option to prospectively elect to segregate certain or all fund assets to support retirement phase interests but would not be defaulted into doing so.

- Any changes take effect from the start of the income year following the legislation receiving Royal Assent. Assuming the legislation is enacted in the year commencing 1 July 2021, it should take effect for the 2022-23 and later income years.

Further detail on our concerns about the proposals is set out in the Attachment to this submission.

We would be pleased to discuss this submission or to provide further information. Please contact the CEO of the Actuaries Institute, Elayne Grace at elayne.grace@actuaries.asn.au. If you wish to clarify any aspects of this submission.

Yours sincerely

Tim Jenkins
Convenor Superannuation & Investments Practice Committee

Attachment

In this Attachment we set out our detailed feedback regarding aspects of the proposed legislation. Note that in our discussions in this submission we assume that all retirement phase interests are account-based type income streams and not defined benefit pensions.

Detailed feedback on 'Requirement for actuarial certificates for certain superannuation funds' draft legislation

As noted in our previous submission on 14 February 2017, the Institute is supportive of removing the anomaly where a fund with disregarded small fund assets while also being solely in retirement phase for an entire income year is required to use the proportionate method to claim ECPI. The changes proposed will remove the unnecessary requirement to obtain an actuarial certificate to claim ECPI.

We take this opportunity to note that the disregarded small fund assets legislation applies to funds where members have a total superannuation balance that exceeds a threshold of $1.6 million (among other requirements). This threshold is not indexed or linked to other legislative caps such as the general transfer balance cap. It therefore has the potential to confuse and complicate administration. To simplify the system, it would be worth considering linking this threshold to the general transfer balance cap.

Detailed feedback on 'Providing choice for trustees calculating exempt current pension income' draft legislation

Effect of proposed legislation:

A closer look at the draft legislation reveals that:

1. A superannuation fund trustee is required to make a choice as to whether an asset of the fund is or is not a segregated current pension asset during a period, being less than a whole year, where the fund consists wholly of retirement phase pensions.

   There appears to be no default position – for example, that the fund assets during a Relevant Period (where the fund consists wholly of retirement phase pensions) are treated as segregated current pension assets, unless the trustee chooses not to treat them as such. Rather, the draft legislation requires a trustee to make a choice, either for an asset to be segregated or not.

2. A choice will have to be made on an asset by asset basis.

   An asset will include individual tax parcels, for example where there have been multiple acquisitions of the same listed share. This could mean quite a number of choices that will be required to be made by trustees for assets to be or not to be treated as a segregated current pension asset during a Relevant Period.

3. The choice of which method to be used for which asset and when will be made in arrears.

The draft legislation states that the fund "may choose to treat an asset of the fund as being, or not being, a segregated current pension asset of the fund ***at a particular time*** in an income year…".

Where a fund uses the proportionate method to claim ECPI, this is applied on a retrospective basis. That is, after the relevant income year, the trustees obtain the relevant actuarial certificate and apply the exempt income proportion to the fund's eligible income and claim as exempt.

When a fund moves into a period where all its assets are supporting retirement phase interests it is not a deliberate choice of the trustees. It is a consequence of member actions such as commencing an income stream or meeting a condition of release. Under the current rules, all assets are deemed to be segregated current pension assets during a Relevant Period. ECPI is claimed under the segregated method for income in this period retrospectively based on whether assets were deemed to be segregated or not. (It is worth noting here that where the fund *elects* to segregate specific assets to support retirement phase interests, this is currently required to be done on a prospective basis.)

The proposed legislation therefore seems to allow trustees to make the choice over whether an asset is a segregated current pension asset during a Relevant Period *retrospectively*. We believe that this will give rise to structuring of choices to ensure the optimal tax outcome is achieved. It may also require numerous comparative calculations to determine that optimal outcome. Indeed, such strategies would be an expected outcome of the legislation.

Even if the legislation were clarified to ensure that decisions regarding which ECPI method/s to use should be made in advance, issues would arise. In some circumstances, trustees may be unaware of when a Relevant Period is about to commence and hence that the relevant choice needs to be made for assets that the fund holds at that time. Further, the trustees would have to make a similar choice for any assets acquired during the period, where the fund consists wholly of retirement phase pensions. As there appears to be no default position of an asset's status during such a period, what happens where the trustee has not made the prospective choice?

The extent of the complexity introduced by the draft legislation and the ability for funds to optimise their tax outcomes is best illustrated with a couple of examples.

Example 1

Consider a fund that has an income year where it consists wholly of retirement phase pensions for a period and during other periods has both accumulation and retirement phase interests, and it does not have disregarded small fund assets for that income year. During the Relevant Period the fund disposes of two assets, one for a capital gain and the other for a capital loss. Under the proposed legislation the trustees will be able to make the choice, retrospectively, to treat the asset that gave rise to a capital gain as a segregated current pension asset, but not to treat the asset that gave rise to a capital loss as a segregated current pension asset. Consequently, the gain from the segregated current pension asset is fully exempt from tax, but a portion of the capital loss from the asset not treated as a segregated current pension asset can be offset against assessable capital gains or carried forward to a later income year under the proportionate method.

Example 2

Consider a two-member self-managed superannuation fund claiming ECPI in the 2019-20 income year:

- Both members are in accumulation phase on 1 July 2019
- Member 1 turns 65 and starts an account-based pension with their entire balance on 1 November 2019
- Member 2 retires on 1 March 2020 and starts an account-based pension with their entire balance

For ECPI purposes, there are three distinct periods:

1. 1/07/2019 to 31/10/2019 – fund is wholly in accumulation phase
2. 1/11/2019 to 28/02/2020 – fund is in both accumulation and retirement phase
3. 1/3/2020 to 30/06/2020 – fund is wholly in retirement phase

The fund earns income as follows:

- Dividends of $20,000 paid on 30 September 2019
- Managed fund distribution of $30,000 on 30 June 2020

Claiming ECPI under current legislation:

Assuming the trustees had not elected to segregate specific assets in advance, under the current legislation ECPI would be claimed for the fund above as follows:

- For periods 1 and 2 ECPI would be claimed under the proportionate method. Superannuation liabilities that relate to these two periods would be included in the actuary's certified calculation of the exempt income proportion. This tax-exempt proportion would be applied to the total income and net capital gains earned across both periods 1 and 2 to determine the ECPI for these periods. Assuming a tax-exempt proportion of 25%, ECPI in this period would be $5,000 (25% x $20,000)
- Income and net capital gains earned during period 3 would be exempt from tax under the segregated method. The managed fund distribution of $30,000 would be ECPI.
- Total ECPI for the income year would be $35,000.

Claiming ECPI under proposed legislation:

If the proposed legislation applied in 2019/20, the trustees would have a number of different options for claiming ECPI. During period 3 when the fund is wholly in retirement phase the trustees have the option of deciding which assets can be treated as segregated current pension assets and on which dates during the period.

Possible options include:

1. They could opt to treat all fund assets as segregated current pension assets for the entirety of period 3. This gives the same outcome as under the current legislative resulting in a total ECPI claim of $35,000.
2. They could opt for all fund assets not to be treated as segregated current pension assets for the entirety of period 3. All ECPI would be claimed under the proportionate method.
   - When the superannuation liabilities in period 3 are included in the actuary's calculation the exempt income proportion will increase, say to 50%.
   - This higher proportion is applied to all income and net capital gains, resulting in total ECPI of $25,000 (50% of $50,000).
3. The trustees could opt for the fund's assets to be segregated current pension assets only on 30 June 2020 with the proportionate method being applied to income earned on all other dates.
   - The managed fund distribution received on 30 June 2020 when the fund's only assets were segregated current pension assets would be exempt from tax
   - All other liabilities would be included in the actuary's calculation of the exempt income proportion under the proportionate method. The tax-exempt proportion will be only very slightly lower than in option 2, say 49.5%.
   - Total ECPI for the fund would therefore be all of the $30,000 managed fund distribution plus the exempt income proportion times the remaining fund income and net capital gains. This gives total ECPI of around $39,900.
4. The trustees could further optimise their tax outcome by looking at segregation on the individual asset level. Opting to treat only the managed fund investment as a segregated current pension asset only on 30 June would provide an even higher ECPI claim than in option 3.

This is a simplified example. Clearly for a real fund with a range of assets and different income and capital gains events assessing possible strategies and outcomes would be significantly more complicated. A fund may also have more than one period during an income year where they are solely in retirement phase. The scope for optimising tax outcomes would increase substantially.

Conclusions

As illustrated above, the ECPI Choice proposals will provide trustees with a wide range of possibilities for how to claim ECPI. While some trustees may use the new rules to opt for an approach that reduces administrative complexity, for example using the proportionate method for the whole year, we believe that many will feel that the alternatives need to be considered to ensure the best outcomes for their members. In some cases, this will mean a number of different tax calculations need to be performed to determine the best outcome. Clearly this adds to administrative complexity and cost rather than reducing it.

The Federal Budget papers noted that these proposals are expected to be tax neutral. However, the Institute believes that their practical application is likely to see funds optimising their tax outcomes in these circumstances and therefore reducing the overall tax revenue.

We do not believe that the intent behind the proposals is to provide this level of choice to trustees. As noted in the draft Explanatory Materials (1.13 and 1.14), the problem that the legislation is aiming to resolve is the complexity introduced with the release of the ATO's view in 2017 that where a fund's assets are held solely to discharge liabilities in relation to retirement phase interests for any part of the income year, those assets are segregated current pension assets for that period. This has resulted in funds having to claim ECPI under both methods in the same year, complicating administration.

In our view, the simplest way to remove this complexity is to amend the existing legislation so that all of a fund's assets are only deemed to be segregated current pension assets where all those assets are held solely to discharge liabilities in relation to retirement phase interests for the *whole* of the income year. That is, a fund will be deemed to have segregated current pension assets if, for the whole income year, it only has retirement phase interests.

Compared to the existing legislation, such an amendment would not reduce the choices available to trustees with regard to claiming ECPI. Trustees could still use the existing provisions to elect to segregate certain assets to support retirement phase interests if they choose to do so. However, by removing the compulsion to use the segregated method, except where it is simpler to do so, administrative complexity will be reduced. It would also avoid introducing the ability for trustees to optimise their tax outcomes and thus provides a solution that does not impact tax revenue.

Commencement of Legislation

Both measures are slated to commence at the start of the quarter after the legislation receives Royal Assent. However, the draft legislation also refers to the measures taking effect for the 2021-22 income year. Given the timing of the consultation, it is very unlikely that the legislation will be passed before 30 June 2021. We will therefore have the situation where the legislation will be passed and commence after the start of the income year in which it takes effect.

The 'Requirement for actuarial certificates for certain superannuation funds' measure is relatively straightforward and is unlikely to alter trustees' and members' decision making. It also only impacts a few hundred self-managed superannuation funds. The Institute is therefore supportive of the proposed timing for this measure.

The second measure, 'Providing choice for trustees calculating exempt current pension income', has far more significant impacts on members, trustees and the broader industry. The new rules as proposed in the draft material would be likely to change trustee behaviour in affected funds, as they look to adapt and make the most of the new structure. Trustees would therefore be making decisions without clarity on what the rules are for the 2021-22 income year.

Changes of this scale will also require significant updates to software and systems. SMSF accounting software and actuarial certificate providers will need to make changes their systems.

Administrative systems and processes, legal documentation and advice processes will also need to be amended.

To allow service providers time to prepare for the changes before they take effect and so as not to detrimentally impact taxpayers, we recommend that the ‘Providing choice for trustees calculating exempt current pension income’ take effect from the 2022-23 income year.