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RE: Division 293 tax – Calculating notional contributions for defined benefit funds

The Association of Superannuation Funds of Australia (ASFA) is pleased to provide this submission in response to the request for comments on exposure draft regulations prescribing the methodology for determining defined benefit contributions for Division 293 tax purposes in respect of the 2013-14 financial year and subsequent years.

About ASFA

ASFA is a non-profit, non-politically aligned national organisation. We are the peak policy and research body for the superannuation sector. Our mandate is to develop and advocate policy in the best long-term interest of fund members. Our membership, which includes corporate, public sector, industry and retail superannuation funds, plus self-managed superannuation funds and small APRA funds through its service provider membership, represent over 90% of the 12 million Australians with superannuation.

General comments

Following consultation with our members, ASFA wishes to advise that it strongly supports the use of Notional Taxed Contributions (NTCs) as the relevant method of calculating the value of employer contributions to a defined benefit fund. The NTC methodology is simpler and will have substantially lower compliance costs than the methodology proposed in the mid-2013 exposure draft. However there are some concerns with the drafting and the variation in methodology between calculating NTCs under Division 293 of the *Income Tax Assessment Act 1997* and that currently used for the purposes of Division 292. These concerns are set out in the next section.

As the Division 292 NTC calculation method has been in place since 2007 and is now reasonably well understood the adoption of this method for Division 293 tax purposes is clearly preferable to the approach proposed in the earlier exposure draft. As advised previously, adoption of the NTC reduces compliance costs from those which otherwise would have been incurred.

ASFA considers that, in making the Division 293 regulations, the Government also should address the significant number of outstanding issues associated with the determination of Division 292 NTCs and the operation of the grandfathering rules. With the substantial adoption of the Division 292 methodology for Division 293 purposes it has become even more important that these issues be resolved without further delay.

Specific comments

ASFA has concerns over the drafting of the proposed amendments to the *Income Tax Assessment Regulations 1997* ("ITA Regulations") and specifically with respect to proposed regulation 293-115.15. Sub-regulation 293-115(2) defines a "funded benefit interest" as an "interest in a complying superannuation fund that is not a constitutionally protected fund". Schedule 1A of the ITA

Regulations (which is relevant for the 2012-13 year) uses a definition of "fund benefit" which is different to the definition of "fund benefit interest" in the draft regulations for Division 293 purposes.

This proposed definition is very broad and would apply to most DB funds. The explanatory statement provides some clarity that the regulation is intended to cover only "fully funded defined benefit interests". Where that is the case, the rules going forward are the same as for the 2012-2013 year but without the grandfathering.

However, where the fund is not a 'fully funded defined benefit fund', it is necessary to refer to sub-regulation 293-115.20(2) (which provides for defined benefit contributions for accruing members with defined benefit interests other than fund benefit interests). You then need to look at the method in Schedule 1AA in the draft regulations and engage an Actuary to determine the "employer funded component". The explanatory statement provides that, in such circumstances, a fund will need to report two amounts to the ATO:

- the component representing benefits sourced from concessional contributions (calculated under Schedule 1A of the ITA Regulations without the grandfathering); plus
- the employer financed component of the benefits which are not sourced from concessional contributions (which is the difference between notional employer contributions and notional taxed contributions calculated under Schedule 1A).

ASFA's preference is for the adoption of the simpler approach of the Division 292 NTC calculation methodology with a small modification to exclude the grandfathering provision. The revised methodology is still burdensome and requires another actuarial calculation leading to additional costs that will be borne by all members of a fund.

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The drafting approach

ASFA has concerns with the lack of consistency in the drafting approach. In some places a minimalist approach is adopted with cross references to existing provisions with a minor adjustment. In other places, existing regulations are replicated verbatim. For example:

- Regulation 293-115.15(4) follows Division 292 but ignores the grandfathering rules.
- Schedule 1AA clause 3(2) is identical to Schedule 1A clause 1.4 except it substitutes 'defined benefit contribution' for NTC.
- Schedule 1A clause 5 is substantially the same as Schedule 1A, clause 2.1 except it refers to 'benefits payable' instead of 'fund benefit' and does not include the 'for the avoidance of doubt' provision in Schedule 1A clause 2.1(4).

ASFA requests that the drafters either set out fully, complete and self-contained regulations for Division 292 and 293 or have the Division 293 regulations consistently refer back to Division 292 with any necessary adjustments. ASFA considers that using a mix of drafting styles makes the task of accessing and complying with the regulations more difficult.

Of more concern are the following inconsistencies:

- Item 2 inserts a signpost definition into sub-regulation 995-1.01(1) for 'accruing member', which specifically refers to the modified meaning of that term in subdivision 293-DA and Schedule 1AA. This is potentially confusing as 'accruing member' is also a relevant concept in Division 292 & Schedule 1A, but that is not signposted in 995-1. In contrast, item 3 repeals an existing signpost definition of 'new entrant rate' (which currently is specific to Schedule 1A) because that term will now also be relevant to Schedule 1AA, when it could simply have pointed to both Schedule 1A AND 1AA, as being relevant..
- The result is that there are now (different) definitions of 'accruing member' in both Schedule 1A & 1AA. Ideally each definition should make it clear that it only applies for the purpose of that specific Schedule– especially so given that the new proposed signpost definition in 995-1.01 only refers to Schedule 1AA. A similar replication issue exists with 'benefit category' except that there is no signpost definition for it.

ASFA questions whether there is a need to replicate (or pick up via cross referencing) Schedule 1A clause 2.6 regarding the new entrant rate if the member changed benefit category during the year. Schedule 1AA clause 3 makes it clear a member generally should be in only one benefit category at any given time (as does Schedule 1A, clause 1.4) but nowhere in Schedule 1AA does it recognise that a member can move between categories during the year.

Outstanding issues with the Division 293 tax

With the making of these regulations, the law supporting Division 293 tax largely will be settled. However, there are some matters pertaining to this measure that are causing some concern to parts of the superannuation industry which we believe require further analysis, clarification and possible amendment via legislative instrument to facilitate the smooth functioning of this new tax. These matters are set out below.

Income stream commutations

In December 2013, the *Superannuation Legislation Amendment (2013 Measures No 2) Regulation 2013* amended the *Superannuation Industry (Supervision) Regulations 1994* ("SIS Regulations") to enable amounts to be paid from an individual's superannuation or income stream under a release authority to meet tax liabilities arising from certain superannuation contributions. The change was affected by inserting a new provision, sub-paragraph 1.06(2)(e)(vi)(C), into sub-regulation 1.06(2) which deals with the commutation of a pension. However, under this provision, to give effect to a release of a Division 293 tax amount would appear to require an adjustment to the ongoing value of the pension, necessitating the full commutation of the pension and its replacement with a new defined benefit pension reflecting the payment of the tax. Under the rules of some schemes, to give effect to a Division 293 release authority would require the commutation of a life pension into a lump sum benefit, an unsatisfactory outcome for the pension holder.

To improve administrative flexibility ASFA seeks an amendment to paragraph 1.06(2)(b), the provision which sets out the circumstances under which the size of a benefit in a year may be varied. Currently, under sub-paragraph 1.06(2)(b)(ii), a variation of the size of payments in a year is permitted to allow commutation to pay a superannuation contributions surcharge. ASFA considers that for administrative simplicity a similar provision should be made in paragraph 1.06(2)(b) for the payment of a Division 293 tax assessment liability on the presentation by the member of a release authority. Amending this provision would mean that a pensioner could meet a Division 293 tax liability without the need to commute the pension, in the same way they can meet a surcharge liability.

Implementing this change would also overcome a difficulty with ATO administrative processes regarding end benefit notices. The details of this issue are set out later in this submission.

Social Security Act implications of release authorities

Similar to the above issue, the *Social Security Act 1991* outlines consequences for the commutation of long term assets-test exempt income streams. Section 9A of the *Social Security Act* contains the rules for lifetime income streams that are exempted from the assets test. Allowable commutations include, for example, commutations "to the extent necessary to cover any superannuation contributions surcharge relating to the income stream" (under sub-paragraph 9A(2)(h)(iv)). However, it would appear that the *Social Security Act* currently requires the Department of Social Services to treat commutations for the purposes of Division 293 as "non-allowable".

ASFA requests that consideration be given to the need to amend the *Social Security Act* to treat ATO release authorities with respect to Division 293 tax assessment on the same basis as those with respect to surcharge liabilities.

Preparation of end benefit cap notice

Section 133-140 of Schedule 1 to the *Taxation Administration Act 1953* requires funds, in certain circumstances, to give a notice to the Commissioner stating the amount of the 'end benefit cap'. Section 133-120 states that the 'end benefit cap' is 15% of the *employer-financed component*. However, 'employer-financed component' is an undefined term. Funds have been advised by their actuaries that, without ATO guidance on the appropriate calculation methodology, the actuary is unable to determine this figure.

ASFA requests that the Treasury seek advice from the ATO on the need for regulatory clarification on this point.

Administration of debt accounts

ASFA members have raised concerns over the practicality of the proposed process for members who have deferred debt accounts and who chose to take their benefit as a pension. Although this primarily is an ATO administrative issue, it is raised in the context of this submission as a regulation change may be necessary to provide the solution.

Draft ATO release authority paperwork indicates that funds:

> *…must provide this information on the End benefit notice – superannuation provider (NAT 74728) within 14 days of receiving the benefit request from the member, or the superannuation benefit becoming payable (whichever is earlier).*

This process is confusing to members and its implementation is problematic.

The general process for a defined benefit member (or any member) to request a benefit payment is not to seek payment at a future specified date but rather to merely request payment. Processing the benefit payment would then be subject to normal processes including, in some funds, an obligation to fulfil that request in a specified time frame. While this does not affect a fund's ability to issue a notice to the ATO in the approved form within the legislated time-frame, it does mean that, generally, the defined benefit will have been dealt with (i.e. taken as a pension or lump-sum) prior to the ATO issuing a release authority to the taxpayer.

In such circumstances, the member's attempt to avail themselves of the ATO release authority will be defeated as the defined benefit has already been dealt with. If taken as a lump-sum, for example, a different accumulation-style release authority will need to be issued. If taken in the form of a defined benefit pension, under the current rules that pension will need to be fully commuted to a lump-sum and the member's pension rights may be terminated.

ASFA suggests that an alternative approach may be for a debt account to be discharged either by voluntary payment(s) prior to an end benefit being payable, use of a release authority from an accumulation interest (either before or after an end benefit has been paid) or by permitting the release (i.e. partially commuting) of funds from a defined benefit pension. (See above regarding a recommended regulation change to this effect.)

Adopting the above approach could ensure no undue encumbrances are imposed on member's accounts and also limit the amount of complexity and cost in administering the member's interest.

Explanatory Statement

ASFA has reviewed the draft Explanatory Statement and has only the following comment to make about the content:

Page 1, paragraph beginning 'The Regulator provides that ….", third line.

The word 'be' should be inserted between the words 'to paid'

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Outstanding issues with the Division 293 NTC methodology

ASFA members have passed on to us concerns raised by their actuaries in relation to Division 292 notional taxed contribution arrangements which have applied to defined benefit interests for the purposes of the limits on superannuation contributions since 1 July 2007.

These concerns relate to:

- the operation of the grandfathered cap provisions for defined benefit members which, despite the July 2009 amendments to the *Income Tax Assessment Regulations 1997*, remains a significant barrier to a number of fund mergers;
- the need for further clarification of certain aspects of the grandfathered cap; and
- the need for clarification of the operation of the components W, X, Y and Z of notional taxed contributions.

Our advice is that, since their introduction, actuaries have encountered numerous situations where the regulations relating to notional contributions are ambiguous or seem to provide unreasonable outcomes. This has led to ongoing confusion and, in many cases, significant problems and additional costs for employers and trustees who are endeavouring to keep faith with their employees and members by continuing the practices and commitments that existed prior to the implementation in 2007 of the Simpler Super arrangements.

With the significant reduction that has occurred since 2009 in the concessional contribution limits, these problems have now become more acute. ASFA urges that the existing Regulations need to be reviewed in order to provide greater clarity and more logical outcomes. Rather than setting out the details in this submission, we refer you to the Actuaries Institute's submission of 6 May 2010 which was supported at that time by ASFA.

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I trust that the information contained in this submission is of value.

If you have any queries or comments regarding the contents of our submission, please contact ASFA's Principal Policy Adviser, Robert Hodge, on (02) 8079 0806 or by email rhodge@superannuation.asn.au.

Yours sincerely

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