FSC FINANCIAL SERVICES COUNCIL

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The Treasury
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Subject: Income Tax Assessment and Other Legislation (Sustaining the Superannuation Contribution Concession) Amendment Regulation 2013

Dear Sir/Madam

The Financial Services Council (FSC) welcomes the opportunity to comment on the draft Bill to implement the 2012-13 Budget measure to implement the higher concessional contributions tax rate for those Australians earnings over $300 000 per annum.

The FSC represents Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks, private and public trustees. The FSC has over 130 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 Securities 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.

Summary

The FSC is concerned in relation to the defined benefit aspects of these regulations. They impose an unnecessary methodology which will result in:

- Significant and unnecessary cost increases and inefficiencies for defined benefit funds. The costs arising will be totally out of proportion with the likely tax to be collected. The costs involve include actuarial costs, the costs of changing administration systems and the costs of communicating to members;
- Significant confusion for members who will now have two different notional contributions – one for excess contribution tax (ECT) purposes and a different contribution for the additional contribution tax for those earning more than $300 000;
- Very substantial delays in reporting notional contributions for the 2012/13 year;
- Likely delays in funds reporting these notional contributions in later years due to the calculation complexities;
- Difficulties in reporting in respect of members whose benefits have been rolled over during the 2012/13 year.

These issues are particularly concerning when there is an appropriate alternative methodology which is already in place and could be used at virtually no cost by almost all funds for the purposes of the additional contribution tax. This existing methodology is currently used for ECT purposes by all defined benefit funds paying taxed benefits as well as some paying untaxed benefits.

The only defined benefit funds who do not have a notional taxed contribution (NTC) for ECT purposes are a handful of Commonwealth Government schemes and constitutionally protected State Government schemes. We consider it is totally inappropriate to design the requirements around a small group of public sector arrangements when the outcome results in additional cost and inefficiency for all private sector funds and those public sector funds for whom NTCs already apply.

The FSC recommends that the draft regulation should be rewritten to set the method of calculation as the same method as used for excess contributions tax purposes.

We accept it may be necessary to adopt the ECT method ignoring the grandfathered cap. In some cases this will result in the additional contribution tax being applied to notional contributions well in excess of $25 000.

This will require relatively minor changes to administration systems to report the uncapped as well as the capped ECT notional contribution.

However, a practical approach will be required in respect of rollovers in the 2012/2013 year. Contributions for these members will need to be reported by the fund which received the rollover, however it will have no details of the uncapped notional contribution.

For this reasons the FSC also recommends that for rollovers in the 2012/13 year, notional contributions should be equal to the capped NTC amount as this is the only amount rollover funds will have available.

In any event, the draft regulations are, at best, unclear and include significant deficiencies. Unless these deficiencies are addressed, if experience with the previous superannuation surcharge is any guide, there will be ongoing debate about the calculation process, considerable uncertainty, protracted disputes with the ATO, legal challenges to assessments and further disenchantment and even greater costs imposed on superannuation funds. We cover some of these deficiencies in Appendix 2. However, even if these deficiencies are properly addressed, the proposed method remains costly and complex.

Please feel free to contact me on 02 8235 2566 if you have any further questions or comments in relation to this submission.

Yours sincerely

BLAKE BRIGGS
SENIOR POLICY MANAGER

APPENDIX 1

Cost impact on defined benefit funds

Actuarial costs

The costs involve in implementing the draft regulations will be very considerable and out of proportion to the tax which will be collected. All defined benefit funds will be impacted, including those funds where few, if any, members have income anywhere near $300 000.

Funds will need annual actuarial certification of the defined benefit contributions as benefit levels will potentially change every year due to the annual increases in the Superannuation Guarantee. This will apply irrespective of whether any of the fund's members exceed the income threshold.

The annual cost of this certification will vary considerably from fund to fund. Once the methodology and processes are established, we expect it will range from around $5 000 for a simple fund with one or two defined benefit members to over $50 000 for a large, more complex fund.

Costs in the first year are likely to be significantly higher as it will be necessary to develop processes relevant to each particular fund to determine the defined benefit contributions.

In relation to defined benefit plans in master trusts, the costs indicated will apply to each defined benefit plan in the master trust. As there are hundreds of such trusts in the industry, the cost of these changes will amount to millions of dollars.

Administration costs

The actuary may provide a certificate which lists the notional contributions for each member. On the other hand it appears possible to provide a multi-dimensional table of contribution rates with rates varying depending on the member's age, sex, salary, period of membership, benefit category, accumulated benefits as well as other factors.

The fund will then need to amend its administration system to accept and apply the notional contribution data/multi-dimensional table.

At some stage in the process it will be necessary to modify the numbers provided or determined to reflect members who have been in the fund for only part of the year.

Further actuarial advice would be required where members have changed benefit category, chosen a benefit option and in other circumstances.

The cost of changes to the administration systems are therefore difficult to estimate as the cost will partly depend on the format of the actuary's advice. For example, the actuary may provide:

- Specific defined benefit contributions for each member which take into account the period in the year for which the member was a member
- Specific annualised defined benefit contributions for each member which the fund will then need to adjust to reflect any periods for which the individual was not an accruing member
- Additional advice on how to adjust the defined benefit contribution where a member transfers from one category to another

- A multi-dimensional table of defined benefit contribution rates which would need to be built into the fund's administration system, and then used by the fund to determine the defined benefit contribution. The rates in the table could vary depending on the member's age, sex, length of membership and other features depending on the particular fund. Thus, across the industry, there is likely to be a range of tables with different features.

We note the variety of actuarial methods which may be adopted to best suit each fund will create further problems for administration systems as the changes necessary will vary from fund to fund. In other words it will not be possible to apply the same change to all funds using the same administration platform.

It would not surprise us if the costs of these systems changes amounted to a one off cost of similar magnitude to the annual actuarial costs (or higher). Yet it would not stop there as higher costs would also be incurred on an ongoing basis.

Communication costs

Funds will also incur additional communication costs, trying to explain why there are two different notional contribution numbers for each member. This will be far harder to explain than why a notional taxed contribution is capped for one purpose but not for another.

We note it will not just be the initial communication involved. We expect funds will need to respond to complaints from members who feel aggrieved by being subject to the new tax. Explanations of the different methods will again be required. Bearing in mind the deficiencies in the draft regulations and experience with the previous surcharge, we expect many of these complaints could end up in the SCT or in legal action. This will involve further ongoing costs, irrespective of the outcome of the complaints/legal action.

Communication costs are also likely to be higher as the defined benefit contribution will change each year. Further it will generally not be possible to determine the defined benefit contribution until after the end of the relevant tax year, making contribution planning very difficult for some members.

SMSFs

Defined benefit SMSFs would also be required to obtain actuarial certification. Again, the actuarial costs may be in line with the estimates outlined above, perhaps $5,000 bearing in mind the small membership. Clearly this is a significant impost on an SMSF, particularly where the members are fully aware their income is well below the $300,000 limit.

We note SMSFs are currently subject to a different method of determining NTCs for ECT purposes. In effect the actual contributions must be apportioned between members. Using the same notional contribution as used for ECT purposes (the apportioned contribution) will again result in significant cost savings compared to the method in the draft regulations.

General

We also note the proposed methodology, whilst similar to the method adopted for surcharge, is likely to be more difficult to apply in a practical manner than in relation to surcharge.

In particular the use of multi-dimensional contribution rate tables will be more difficult or unworkable as the number of dimensions which need to be taken into account will increase due to:

- The minimum benefits to comply with Superannuation Guarantee having reached levels where the minimum benefit may regularly apply;
- The requirement (from 2008), to base minimum benefits on Ordinary Time Earnings rather than superannuation salary as used for other benefits in the funds.

The significantly lower number of defined benefit members in most defined benefit funds will also remove the advantages of using multi-dimensional tables.

Further, new certificates will be required each year due to the annual increases in the Superannuation Guarantee.

Strain on resources

Superannuation funds and their service providers are currently under huge strain due to the significant amount of reform occurring in the superannuation system. This strain is on trustees, administrators, administration systems, advisers and actuarial resources.

To impose the proposed requirements as set out in the draft regulations at this stage will create even further strains. This will potentially result in the breaking point being reached for some funds with subsequent breaches and/or errors occurring in any one of a number of areas. For example, the pressure to implement the proposed defined benefit contribution methodology could mean other aspects of a fund's operation are overlooked.

Yet, this problem could be solved by using the notional contributions as determined for ECT purposes. These numbers are, except for a handful of public sector schemes, already available and already programmed into administration systems. Whilst some modifications to administration system would be required, the amount of change is vastly less than would be required under the requirements in the draft regulations.

Confusion for members

Defined benefit members would need to be provided with two different notional contributions – one for ECT purposes and one for the new additional contributions tax purpose.

This is likely to result in considerable confusion and make it more difficult for some members to properly plan their contribution strategies.

The use of the NTC methodology for both purposes will considerably reduce this confusion, even if the grandfathered cap is not applied for the purposes of the new tax.

Delays in reporting

As indicated in Appendix 2, there are many deficiencies in the methodology set out in the draft regulations. As they stand, it would not be possible for actuaries to provide the required certification due to the lack of clarity, the many ambiguities and inconsistencies in the draft.

Unless these deficiencies are addressed, there will be ongoing debate about the calculation process, considerable uncertainty, protracted disputes with the ATO, legal challenges to actuary's certifications and ATO assessments, further disenchantment and even greater costs imposed on superannuation funds.

Ideally the multiple discrepancies should be fixed in the regulations themselves. However the delays in issuing even draft regulations has left little, if any, time to make the major modifications necessary or even to consider potential other shortcomings that might arise when putting the regulations into practice.

Even if significant improvement can be made to the regulations, it is likely they would need to be accompanied by an ATO Ruling and/or professional guidance from the Actuaries Institute. The Institute cannot commence consideration of this matter until the Regulations have been finalised. It is inevitable that delays will occur.

The complexities are so great, it is unlikely reasonable rules could be finalised before October 2013.

Once this has occurred, funds would need to obtain complex and costly actuarial advice. Only after this advice has been obtained will it be possible for funds to commence amending their administration systems to calculate and record the required information, as well as amending administration systems to enable reporting to the ATO.

We expect many funds would be unable to report much before 1 July 2014 even if the regulations are appropriately clarified before October 2013.

This will result in further costs to defined benefit funds as presumably, the normal MCS reporting (without the defined benefit contribution details) would still be required by 31 October 2013 to avoid holding up reporting for other purposes such as ECT. Presumably funds would need to lodge amended reports once the defined benefit contributions become available.

Reporting delays will be significantly reduced and possibly removed altogether if the NTC approach used for ECT purposes is adopted for purposes of the new contribution tax.

We also expect the complexity of the proposed method will create difficulties in subsequent years. There is just not enough time for administrators to provide actuaries with the required membership data (including category transfers, exits, benefit options selected during the year and so on), actuaries to provide certification to the funds and funds to load and report the actuary's recommendations by 31 October each year.

In particular, actuarial resources are now under further pressure due to the reduction in the time frame in which to conduct actuarial investigations, the far greater emphasis on actuarial involvement of funds in or close to an unsatisfactory financial position, and the annual increases in the Superannuation Guarantee requiring replacement benefit certificates, funding and solvency certificates and NTC certificates.

Likewise, the other ongoing changes in superannuation are placing further pressure on many other aspects of a superannuation fund's operations.

Specific problem for 2012/13

For the 2012/13 year, there is an additional problem in relation to members who have rolled over their benefits during the year.

Contributions, including capped notional taxed contributions (for ECT purposes) have already been reported to rollover funds who will report these amounts in their MCS reporting. Just one contribution amount has been provided which includes both accumulation contributions and the capped notional taxed contributions.

The defined benefit fund will not be reporting contributions for these members who have rolled over.

Thus the ATO will not be provided with a separate value of the defined benefit contributions for these members.

If defined benefit funds are required to report the proposed defined benefit contributions (to the ATO) for these members, this will result in double counting of the notional contributions previously reported to the rollover fund as well as considerable additional expense to the defined benefit fund.

If the defined benefit fund is required to re-report to the rollover fund, this will result in significant additional costs to both the defined benefit fund and the rollover fund.

As this re-reporting will not be possible until some time after the rollover fund has submitted its MCS reporting, further costs will be incurred by the rollover fund in re-reporting to the ATO.

Such an outcome would be unfortunate, particularly as it has been caused by long delays in the Government's legislative process. A practical alternative needs to be developed for 2012/13.

We note the MCS reporting system will change from 1 July 2013 so that contributions are no longer reported to rollover funds but are instead reported by the original fund. This problem will therefore disappear for subsequent years.

The only logical approach for members who rolled over their benefit in 2012/13 would appear to be to take the combined accumulation and capped notional taxable contribution as reported to the rollover fund into account instead of either the defined benefit contribution as set out in the draft regulations or our recommended use of the notional taxed contribution (which would presumably be uncapped).

This will mean the notional contributions for rollovers may be understated in the first year. Of course, many of these rollovers will have occurred part way through the 2012/13 year and as such, in most cases, the capped amount will not have been reached. Any understatement is therefore unlikely to be significant.

APPENDIX 2

Deficiencies in notional contribution methodology

If the Government proceeds with the proposed approach, the issues below would need to be addressed. However the methodology would remain inappropriate and should not be adopted.

We also note the extremely short period of consultation which has left insufficient time to properly analyse the draft regulations.

We are also reminded of the considerable problems which arose in relation to inadequate legislation in respect of the now repealed superannuation surcharge. Many of these problems resulted from inadequate and poor legislative drafting. Unless the regulations are perfectly clear, it is likely such problems will also arise in respect of this new tax. This will result in even higher costs to funds in defending the method of calculation to members and their legal advisers.

The points below are merely a sample of our concerns – there are many other parts of the draft regulations which we consider need to be better written. We also expect further consideration will indicate additional areas of concern.

Date of calculation

- Except for Item F, the regulations provide no clear indication of the date the calculation is to be performed (e.g. end of year or start of year).
- On the other hand it appears Item F needs to be valued as at the date the event occurred. It would be impractical for other Items to be valued at this date so there appears to be an inconsistency in the valuation date to be used for different Items.
- Further, the regulations provide no indication of whether the calculations should be based on the member's salary at the start of the year or the end of the year (or both).

Vagueness of method

- Regulation 293-115.02(2)(b) is inconsistent with 293-115.02(2)(a)(i) where maximum accrual periods apply.
- The meaning of the words in column 2 of the table in 293-115.02(3) are inappropriate/unclear. It is unclear whether the valuations referred to are the valuations for this purpose or other types of valuation. If the former, then the wording in Item 1 fails to provide a logical outcome in relation to options in the 2012/13 year. If the latter, the outcome is illogical.
- The definition of component A refers to the "the present actuarial value of ….." whereas components B, C, D and F refer to "the actuarial value of ……..". It is not clear why the terminology is different.
- 293-115.02(14) refers to valuations under Part 9 of the SIS Regulations. We note the requirements for valuations (except for SMSFs) are being moved from the SIS Regulations to the APRA Prudential Standards.

Unfunded arrangements

- Throughout the regulations, there are references to funded and unfunded schemes. Generally amounts for funded schemes are to be divided by 0.85 to make an allowance for contribution tax. However, this distinction between funded and unfunded schemes has a major flaw. We note some unfunded schemes pay taxed benefits and hence it would seem more reasonable if the amounts in these schemes were also divided by

0.85. Other schemes may be partly funded and the regulations do not adequately provide for such schemes.

Confused wording

- Regulation 293-115.02(3)(b) is obtuse and its meaning remains unclear.
- The meaning or intention of 293-115.02(4) is also very unclear.

Inflated value of notional contributions

- The component E, expenses, is likely to increase substantially due to the costs of determining and reporting the notional contributions. These costs alone could result in E becoming a very significant component of the notional contribution for some members. This appears unreasonable, particularly when these costs can be significantly reduced by more appropriate regulations. In effect members will be paying tax on the cost of working out their tax! This would be similar to an employee being charged income tax on the costs incurred by his or her employer in withholding PAYG tax, preparing payment summaries and reporting to the ATO.

Double counting

- The regulations result in inappropriate double counting of some aspects (for example item B could double count amounts counted in Items D or F; Item A could double count amounts in Item C).

Barrier to fund mergers

- The definition of F creates another potential barrier to fund mergers where the value of benefits in the continuing fund is higher than the value in the transferring fund solely because of different assumptions being used.

Requirement to use unavailable information

- The table in 293-115.02(11) refers to items such as “the employer-provided component of the standard benefit to which the member is entitled”, “the part of the member account provided by the employer” and “the employer provided component of the actuarial value of the benefits that had accrued to the member”. It is unclear how these amounts will be determined as many defined benefit funds do not keep and have never been required to keep details of the employer provided component. It is also problematic as to how these amounts can be determined as many funds do not keep records of the part of the benefit attributable to member contributions or earnings on those contributions as referred to in 293-115.04.

Superannuation Guarantee increases

- 293-115.03(7) refers to assumptions about future increases in the level of Superannuation Guarantee. The intention of this section is unclear.

Negative amounts

- In some cases, the calculated amounts could be negative: e.g. Item 1 of the table in 293-115.02(11). However, we understand there is no facility for funds to report negative amounts.

Unnecessary work

- In some cases, further detailed and complex calculations will be required when there is clearly no change in the member’s accrued benefit e.g. Item 1 of the table in 293-115.02(11).

Other options

- The regulations do not adequately cover an option for members in public sector funds to take, on retirement, either an untaxed or a taxed benefit.

Non-accruing members

- 293-115.05(4) relates to deferred benefits where no employer financed benefit have accrued to the member during the year. The impact of sub-clause (c) is unclear. At best it appears redundant.

Summary

- If the Government persists with the proposal to significantly increase compliance costs by implementing a methodology of this type, significant modifications will be necessary to the draft regulations. Any revised version would require further consultation – at least with the Actuaries Institute, with a much more reasonable consultation period than the short period allowed for the current consultation process.