smartsuper
superfund administrators

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General Manager
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Dear Mr Lonsdale,

A PLAN TO SIMPLIFY AND STREAMLINE SUPERANNUATION

As an administrator of Self Managed Superannuation funds and Small APRA Funds our organisation deals with all aspects of the administration process. Due to the nature of these types of funds we tend to deal with the most complex aspects of the administration requirements.

As there are over 320,000 self managed and small APRA funds in Australia representing 23.4% by total value (second only to the assets in the retail funds area at 31.9%) and 99.6% by total number of all superannuation entities (APRA statistics March 2006), any administration changes will significantly impact on funds of this type. To put this into perspective, by APRA's figures, there are only about 1,300 public offer funds including retail, corporate and industry funds.

The overall desire to simplify the superannuation area is one welcomed by the whole industry. My comments are designed to give an insight into some of the administration impacts of the announcements and to voice my concern that these changes will increase administration requirements – not only for ourselves and other superannuation administrators but the Australian Taxation Office as well. I have chosen a few of the areas to discuss and would like to advise that I am very happy to make myself available to any committee which wishes to further explore these issues prior to the drafting and implementation of the legislation.

The key areas I have examined are:

- The administrative effects of contribution changes and reporting requirements
- The difficulty of administering the punitive tax rates on contributions (and earnings thereon) that are in excess of the limits proposed
- The contributions limits and their transitional rules and conditions
- Issues related to the new Exempt component calculation and record maintenance
- The administration of Pension Assets
- Substantially Self Employed rule issues
- Dependants and death

My over riding comment is that while the changes have made the ***understanding*** of superannuation to the end user much simpler they will ***increase*** the complexity of administration and therefore the cost of administering all superannuation funds as well as increasing the burden on the Australian Taxation Office if it is to adequately monitor the legislation.

Yours faithfully

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CONTRIBUTIONS

Limit Monitoring and Related Issues

Australians on average have balances in 3 separate funds each. While the Choice of Funds legislation should encourage individuals to pool these into 1 fund, lethargy and inertia will generally see that this trend continues. This makes the monitoring of contributions to ensure they do not exceed the allowable limits significantly difficult as no one fund knows exactly what has happened (at a consolidated level) until the Australian Taxation Office ("ATO") receives the details of the contributions, consolidates the data and then advises back to the fund or funds it selects that penalty tax should have been deducted.

At present contributions are only reported to the ATO on an annual basis and do not need to be lodged until 31 October after the relevant 30 June. Allowing for late return lodgement it may be not until the following 30 June that the ATO can safely say it has received information about contributions from all funds. If the ATO then advises the fund or funds that they need to deduct additional tax from the members contributions and earnings on the excess contributions from the date they exceeded the maximum allowable, you can see that this task becomes exceedingly difficult for the fund involved as:

- The accounts and tax returns for the funds will already have been completed and lodged
- All members will have been advised of their share of the investment returns. If individual members' balances are now reduced by way of additional tax then their share of the profit will go down, while the other members' share of the profits will have gone up. All members will have received their member summaries by 31 December. Will they now need to receive new amended ones?
- It is quite likely that many members will have left the fund that is now required to deduct the additional tax. How will it pass on this information to the new fund that the member has joined? How does the previous fund get back the additional share of the profit that has gone to the departed member that rightly belongs to the remaining members?

The tracking of contributions under the proposed taxpayer based system adds significant administration duties to each and every fund in Australia. The implications are significant in that each fund will need to record the date of each transaction and report that to the ATO (via some method – perhaps mirroring the surcharge reporting) presumably quarterly so that undue tax is not created on contributions made over the new limits, and then wait for the ATO to determine if that contribution is allowable as either a deducted or undeducted amount.

For example - a person has 4 contracted jobs with 4 different employers where each employer is making a contribution to a different fund.

1. There is no current way each fund can know the extent to which a person has contributed to each different fund and as such what tax is applicable to each contribution for that particular fund or to the earnings or capital gains on the contributions made.

2. In this example say for the first company the person salary sacrifices $40,000 to their default fund and he also contributes $20,000 via each of the remaining 3 companies.

3. Each fund will need to report the contributions made and wait for a determination from the ATO as to the deductibility of those contributions. If the person also has made an undeducted contribution of $450,000 2 years ago the outcome would be as follows:

    a. The ATO will need to advise each super fund of the deductibility of the various contributions which it cannot do until every fund in Australia lodges its contribution notices as the ATO does not know which fund(s) the individual is a member of.
    b. The ATO will then indicate to one or more of the funds, presumably based on the dates of the contributions, which one(s) will be required to tax the contributions at 15% and which need to apply the 45% rate.

c. Any additional amount above the $50,000 deductible limit would need to be taxed at the 45% rate or be treated as an undeducted contribution.
d. If the individual previously put $450,000 of undeducted contributions into yet another different fund to the above funds, none of the current funds will know that this has occurred.
e. So how does this fund then know that the member has exceeded their undeducted contribution limit as well and that they will need to return the excess undeducted contributions made to it? The ATO will need to remain the consolidator and regulator of this information.

4. Again what happens to the other members of the funds if they should have received a higher share of the profits?

5. What happens if the fund that is required to return the excess contributions either no longer has the cash (as a result of it already being forwarded to another fund) or the fund value has declined in value (eg due to a downturn in the stock market or a movement in the Australian dollar where the fund has international investments)? If the undeducted excess amount plus its earnings taxed at 45% has to be returned where does the money come from in this case.

How can a portfolio manager manage this risk without holding significant cash amounts and does this put the fund asset values of the other members at risk?

The outcome for the ATO and the super funds will be increased fees to administer and monitor new transaction types which it does not currently have, significantly increased complexity regarding the recording and monitoring of contributions (and earnings on them) and long delays in the lodgement of tax and statutory returns or the requirement to amend the return.

The outcome for fund managers may be lower performance due to higher cash requirements or higher cost to carry put & call options to cover any potential losses.

In effect we have removed surcharge, because of the administrative cost and then added a range of contributions taxes which will have exactly the same, if not greater administrative issues, just worse because they apply to all members unlike surcharge which only related to a small group of taxpayers. This is a significant impost on each and every fund.

3 year averaging – a nightmare to administer

It will be difficult enough for funds to monitor contributions and potential excess contributions in a particular financial year in isolation. While being able to put up to 3 years maximum contributions into a fund in 1 year will be of benefit to those who have uneven income patterns or may receive large lump sums eg from downsizing their house, this will further add to the complexity of records that will need to be retained by both funds and the ATO.

For example, if a fund receives a $150,000 undeducted contribution in a particular year, how will it know if the member have already used up their 3 year maximum (ie $450,000) say 1 year ago or 2 years ago or in fact if they only put in $50,000 2 years ago and $100,000 last year so can actually contribute up to $300,000 in the current year. They will need to contact the ATO and obtain a report (much the same way they currently do to work out a member's reasonable benefit limit after taking into account previous benefit payments) of what their contribution eligibility actually is.

It was announced that the transitional arrangements would be a 3 year provision – if this is based on 3 financial years this has very different administrative issues for the funds and the ATO compared with whether it is 3 actual years from the initial contribution. It would seem that the deductible contributions must be date driven otherwise how does the ATO advise a fund which contributions are allowable and which are not.

Example – if $450,000 was contributed 2 year 11 months and 28 days ago and that date was the 8th July and the individual now on the 6th July puts the next 3 years contributions in, the effect can be astronomical. The strict interpretation would be that the amount was not allowable and must be returned. Currently this would not be advised to the fund for possibly 18 months. So the individual, possibly due to a posting date error or difference between the date the cheque was sent and dated compared to the date of receipt will need to have this amount returned all because of 2 days error.

Consider that the new amount was put into a pension and amounts paid from it for the 18 months it will take for the ATO to advise the undeducted is not allowed, the work to unwind all the transactions, reclaim any tax paid, calculate the tax on the earnings at penalty rates and repay the money is huge, all because the amount is 2 days out yet no one fund knows that until the ATO advises the fund of this.

This is not simple.

Return Lodgement Issues

All APRA regulated funds must lodge their regulatory returns by 31st October of each year. The likelihood of this happening is small given that the ATO will not be in a position to provide the necessary information for any adjustments to be made to the rate of tax applied to contributions and earnings or the necessity to return excessive contributions until after the due date for the funds to lodge their returns. There may well be a material difference in the position of the fund and or member balances depending on the taxes to be applied.

the ATO will have to look at negotiating with APRA to have the deadlines for lodgement of the APRA statutory returns extended, especially for Small APRA funds that are more likely to have excess contributions. With the changes to contribution levels, removal of surcharge and taxes on end benefits it is more likely that more and more people will be contributing larger amounts to superannuation and so become likely to get into the area of potential excessive contributions.

Unfairness of penalty tax rate

There are situations where the penalty tax could be applied in an unfair manner, when the intention was never to end up in an excessive situation. For example - a person is planning to retire in December and so salary sacrifices $50,000 (ie the maximum) to their fund over the first 6 months of the year then retires. 3 months later that company asks the person back to work for 3 months to help clear a backlog. Because they are now employed again, the company must pay the Super Guarantee amount into the fund. As this amount will take the contributions over the maximum $50,000, the SG amount will be taxed at a penalty rate of 45% due to a legislative impost ie the superannuation guarantee levy. They have done nothing wrong by anyone yet they are significantly penalised for doing some work.

Suggestions:

1. Return any amounts and earnings to the taxpayer (from any component of the fund rather than the specific taxed or undeducted contribution) and have the taxpayer take them up as income in the year received at their marginal rate, rather than have the fund try to deal with this.

2. Leave the employer based system as it is (ie the maximum limits are applied at a per employer level rather than a per taxpayer/member level), thus removing the burden of accounting for all of this from the ATO and the fund administrators.

3. The ATO could identify any undeducted amounts that were in excess and issue a notice to the fund to return the excess plus earnings to the member to be taken up in the individual's personal return.

4. How the funds will determine the appropriate rate of return to apply to those earnings will be difficult as they will need to isolate those contributions from the date received and apply a daily rate to the balance which will need to take into account the higher level of tax that will need to be deducted from those earnings. I think that the only working solution would be for the ATO to set a defined return rate to be applied each year (such as they do for setting the interest rate to be applied to loan fringe benefits or the GIC).

Substantially Self-Employed rule

While the deductibility of "self-employed" contributions has finally been brought into line with the deductibility of employer contributions, we still have a system that effectively can prevent an individual from being able to make the $50,000 annual deductible contribution. If an individual receives employer support (ie an employer makes super contributions for them) and their income from this employer is more than 10% of their total taxable income, they are still not allowed to claim additional deductible contributions in their own name.

Examples:

1. An employee on a wage of $50,000 plus SGC super contribution of 9% (ie $4,500) who has other income from dividends or even business income of $100,000 is prohibited from making the other $45,500 of their annual deductible limit as a deductible contribution against this income. It is not possible for this person to salary sacrifice down to an income of $4,500 as the employer does not allow it.

2. An individual not employed by a company and under 65 is entitled to a $50,000 personal deduction. A person who is under 65 but works part time for a company which generates 11% of their income is excluded from making personal contributions

Suggestion:

Abolish the work test and allow contributions to be made until age 75, deductible or undeducted. The substantially self employed rule should be removed given that we have a taxpayer based contribution system proposed. Contributions should be linked to the fact the person is an Australian taxpayer rather than a worker. Currently having 11% of your total income come from an employer prohibits you from making personal contributions even though 89% of your income is derived by the individual.

If we are going to have a taxpayer based contribution limit, what should it matter whether the contribution is made by an employer or by the individual themselves.

Age Based limits

The unique concept of all Australians being equal is utopian with a contribution system that says that both an 18 year old and a 60 year old can claim a $50,000 deduction. The likelihood of an 18 year old doing that is very small (as their income may not even be $50,000 in total) yet if they don't contribute when they are 18, they are significantly disadvantaged when they are older as they can no longer make up for contributions not made when they were younger. Consideration should be given to retaining a staggered age based limit or providing the ability to catch up by using say a last 5 year average calculation. For example, if in the last 5 years you have contributed $100,000 yet were eligible to contribute $250,000, then in the last of the five years you should be able to contribute $150,000.

As the ATO will be required to keep records of all contributions made and when, this should cause no real additional burden, particularly as the maintenance of averaging records will need to be retained for undeducted contributions anyway.

This way the system recognises that people are different and that their ability to contribute to super changes with their age and income level. The focus on providing for retirement income very definitely happens after schooling and mortgage have been dealt with.

Averaging of Undeducted Amounts

It is suggested that this is looked at as an average over 5 years rather than 3. As most Australians who use undeducted amounts do so at the latter end of their working career as part of their retirement plan, the current 3 year proposal simply means that the undeducted amount take longer to get into the fund and does not allow for say downsizing the family home to provide funds for retirement where this releases more capital than the current proposed limits. Any excess amounts realised from doing this would need to be invested elsewhere (at higher tax rates and with the possibility of capital gains tax on cashing to move into the fund) until they could be transferred.

Increasing the averaging to 5 years would simplify the planning process and reduce investment costs by not having to duplicate assets inside and outside the fund and incur additional tax and administration/transaction costs of gradually moving funds across to their super fund.

This contribution should be linked to the work test in the year of contribution as how can anyone tell you for certain if they will be working 3 years into the future.

THE NEW "SIMPLE" PENSION

The introduction of the "simplified" pension makes the pension area much more understandable but does nothing to decrease the administration of the pension.

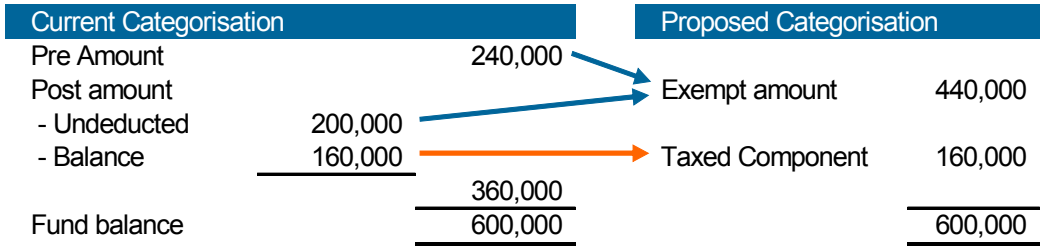
Pensions and the new Exempt Component

It is proposed that we amalgamate all the various components of existing benefits in one calculation as at 30th June 2007 and replace it with a new "Exempt" component. In itself this has a wide range of questions as to the calculation method. Currently the pre / post 83 calculation only occurs when a lump sum is drawn and is only relevant in the pension area where the pension is a pre 94 allocated pension. The calculation currently is dependent on the amount of undeducted contributions within the fund – the larger the undeducted component, the larger the amount which is classified as pre 83.

Example – say the split is 40% pre and 60% post with a total fund value of $400,000. the result is as follows:

Current Categorisation			Proposed Categorisation	
Pre Amount	160,000	→	Exempt amount	160,000
Post amount	240,000	→	Taxed Component	240,000
Fund balance	400,000			400,000

If the fund balance was increased by an undeducted contribution of say $200,000 the calculation will be:



Questions:

1. If the average member has say 3 separate funds, can the balances be amalgamated while still leaving the balances in 3 separate funds or is the calculation to be done on a fund by fund basis? A member may have one fund with a large pre component and another with none, for example.

2. Would the balances all need to be moved into one fund to enable the calculation to be done on the amalgamated balance (this will result in potential capital gains tax being incurred on the exit balances from the other 2 funds)? Should consider one-off exemption from capital gains tax to enable this to happen.

3. If the fund is already in pension mode will the pensions have to be commuted to do the calculation and if so how will this affect any previous calculated deductible amounts or pension conditions or capital gains or income tax?

Tax issues on death

The split into exempt and taxed components still leaves the administrator with the task of monitoring the 2 components as on death the payout will be taxed differently:

For example - if the death benefit is paid to an individual who is defined as a dependant for SIS purposes but not for income tax purposes (eg an adult child):

- the exempt component will remain tax free; but
- the taxed component will be taxed at 15%.

Questions:

1. If pensions after age 60 are not reportable how does the ATO know what components have been taken, given that there is no difference between a pension or a lump sum, neither is reportable after age 60?

2. Will any drawdowns need to be split evenly over the various components or can you choose to draw down all the taxed component first and then the exempt?

3. Will income and gains earned by the fund ongoing be split to each component pro-rata or will they all go to the taxed component?

It would seem that the entire responsibility for determining the split between the components and hence any potential tax liability will rest with the fund administrators (which includes mums and dads who look after their own fund and accountants/bookkeepers with little experience in superannuation) – there will be no records maintained by the Taxation Office to prove or disprove the split or the taxable amount.

While we would like to believe that the fund's auditor should be verifying the split, the Taxation Office indicates it has issues with the way audits are currently being carried out and auditors are not currently even required to have audit qualifications.

Suggestion:

A simple way to reduce the administration on all this area relating to exempt or otherwise components will be to reconsider the tax definition of a dependant to bring it into line with the SIS definition making all amounts paid to a SIS Dependant tax free on death. The anomaly is that if the person is alive and over 60 they can withdraw any amount and give it to whoever they want tax free, whereas if they die it may be taxable – pensioners will need to ensure they withdraw all their money the day before they die! Taxing benefits as they pass to children will be the only form of **death duty** we have. The current proposals say that if the last act of a person is to withdraw their super balance it is all tax free and then can be gifted to spouse or children yet, on death, this is not the case and as a result requires significant administration throughout the life of the person to determine the two remaining components in the event of death.

Monitoring of minimum pension standards

Questions:

1. If pensions are not reportable, how do the legislators know that the minimum standards of pensions are being met? If there is no requirement to advise anyone that a pension has commenced or being paid and the recipient does not need to disclose the pension on their personal tax return, then there is no current method by which a legislator can determine whether the payments of the pension(s) met the minimum requirements, without sending out audit teams into the field.

2. What happens if the minimum standards are not met? Does the fund then go back into accumulation mode, with the pension payments being reclassified as lump sum drawdowns? Or does only part of the fund revert to accumulation mode? This may result in retrospect tax being applied and the need to lodge amending returns i.e. fund moves from being tax free to being taxed (partly or fully).

3. Do the minimum standards need to be satisfied overall or on a per-pension basis (current pension calculations are on a per pension basis)? We have a fund with only 2 members but 22 separate pensions due to the need to provide for different residual beneficiaries. Will each of them need to meet the standard or is it only critical to meet the standard on the total of all the pensions.

As you can see there will be no decrease in the administration requirements for a fund, it will still need to keep component records, asset and payments records and minimum drawdown records, no different to current requirements. The simplicity is in the individual's personal tax return. This was never an issue anyway as the fund would issue a PAYG withholding statement to be included in the personal return, which provided an easy method for the ATO to track payments made against required amounts.

Removal of RBL's for administration purposes.

The RBL calculation was in essence about determining the rate of tax to be withheld (or charged) on any pension or lump sum. Going forward there will still be a need for an administrator to determine what tax is paid and when, so the administration effect of the removal of RBLs is negligible. Payments between age 55 & 60 are still taxable. I estimate that, based on our experience, this will make up approximately 35% of the people drawing pensions – it is not an insignificant number. In addition, payments on death may be taxable depending on the beneficiary and fund tax will need to be paid if minimum pension standards are not met (presumably since there is no method to tax the individual recipient).

The benefit is to an individual as it frees them from needing to worry about whether their fund balance is excessive or not. As such I applaud the move to remove this hurdle.

Pensionable Assets

The release indicated there would be no tax on assets "set aside" for the pension – does this require every fund to now segregate its pension assets, recognising that a person in a self managed fund may have a pension account and an accumulation account at the same time and is likely over their life to end up with multiple pensions running? If so, administratively this requires that each asset be separately tracked to an account, including any earnings, reinvestments and capital gains.

Currently, members can "pool" or share the returns from investments with an internal allocation being made at tax time to determine the percentage of income and gains that relate to accumulation members (ie taxable) and the percentage that belong to pension members (ie tax free). In a self managed fund in particular, segregating assets becomes untenable. For example where the fund holds an investment property as one part of its investment "pool", with 2 members and each member having an interest in the property, the fund would need to hold the asset as tenants in common with itself if one member moves into pension mode, causing possible liability for stamp duty and capital gains tax. In addition, the fund would need multiple bank accounts for each member and each member's particular pension or accumulation accounts.

Without the ability to "pool" investments, costs will rise as the fund would need to maintain details of say 4 different parcels of BHP shares and the fund would need 4 or more separate accounts with the broker in order to ensure that each share is correctly managed for the relevant member account, otherwise it will be difficult to determine which member's parcel has been sold. This will increase the cost to the fund, the member and the broker.

CONCLUSIONS

1. While the proposed legislation is simpler to understand from a fund member's point of view it is certainly not simpler from an administrative point of view.

2. The complexities attached to monitoring an RBL system have simply been moved to the contribution end of the superannuation process.

3. We still have anomalies for self employed contributions although the "75% rule" has been removed.

4. The definition of "dependant" in the Tax legislation is still different from that in the SIS legislation. All SIS dependants should be tax dependants.

5. There is still a need to monitor pension and lump sum components and attribute the amounts drawn to different components (although these have been reduced to 2) as they impact on potential tax for the recipient and/or fund itself.

6. The responsibility of monitoring pension payments has been moved from the ATO to the individual funds with no information being provided to the ATO to enable it to check compliance.

7. Pensions now appear to require specific assets to be "set aside" to provide for the pension creating major issues for funds with pooled/shared assets.