IFSA

Investment & Financial Services Association Ltd

A PLAN TO SIMPLIFY & STREAMLINE SUPERANNUATION

Investment & Financial Services Association

Submission to Treasury

August 2006

A plan to simplify and streamline superannuation

IFSA welcomes the opportunity to comment on the proposals outlined in *A plan to simplify & streamline superannuation* (the Plan) and appreciates Treasury's efforts to engage with industry throughout the consultation period.

IFSA is a national not-for-profit organisation which represents the retail and wholesale funds management, superannuation and life insurance industries. IFSA has over 120 members who are responsible for investing over $920 billion on behalf of more than nine million Australians.

We support the Government's proposals to simplify and streamline the superannuation system for consumers. The proposals outlined in the Plan represent a significant step forward in improving public understanding of superannuation and improving incentives to save.

IFSA recognises the challenges in ensuring the policy detail and legislation are consistent with the objective of simplicity. It will be important to ensure that the required law changes effectively reduce the complexity in the system for consumers while also minimising administration and compliance costs.

We note that there is a significant level of policy detail yet to be announced by the Government and would appreciate the opportunity to work with Treasury and the ATO to provide further comment as this detail develops.

Richard Gilbert
Chief Executive Officer

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1 TAXATION OF BENEFIT PAYMENTS

Below are IFSA's comments on the proposals set out in Chapter 2 of the Plan. In the context of greater simplification for consumers, the removal of tax on benefits for individuals aged 60 and over and the removal of RBLs is welcome. IFSA would like to discuss the following views and engage in the more detailed development of legislation to implement the significant changes involved in a new end-benefit regime.

Removal of tax on superannuation benefits taken post age 60

Exempt/Non assessable non exempt

Under the new regime, payments from superannuation funds to members over 60 years of age will be "tax free". There are two fundamental types of tax free income for the purposes of income tax law. These are "exempt income" and "non assessable non exempt income" (section 6 – 23 of the *Income Tax Assessment Act 1997*). If the first type is applicable, complications arise for taxpayers with losses or those making charitable donations.

It is suggested that pension and lump sum payments to those over 60 years of age should be "non assessable non exempt income" rather than "exempt income".

Timing of tax exemption for individuals reaching age 60

Under the Plan, a benefit/pension payment made to a member will be exempt from tax if the member is aged over 60. Pursuant to the aim of simplicity for both members and providers, IFSA suggests the following options in the administration of this aspect of the Plan:

<u>Option 1 (preferred)</u>
Make payments exempt from tax from the commencement of the financial year in which the member turns 60. This means it would be possible for members to receive tax free payments while still age 59. However, this would be a much simpler system for retirees and would tend to promote an orderly drawdown of their benefits over the course of the financial year without having regard to a particular date specific to their own circumstances. Making payments exempt from tax on or after a member's 60^{th} birthday will encourage member behaviour to be dictated by the occurrence of that date. For this reason we do not believe the revenue consequences of adopting option 1 would be material.

<u>Option 2</u>
If option 1 is not acceptable, IFSA suggests that any payments made on or after the date the member turns 60 are exempt from tax. Providers of pensions would withhold tax using the appropriate PAYG table based on frequency of payment and then simply cease to withhold any tax following the member's 60^{th} birthday. In adopting this approach, a level of simplicity would be achieved as providers and members would not be forced to undertake pro-rating calculations to determine which portion of payments made during the year are tax exempt.

Crystallisation of pre 1 July 1983 component

IFSA supports the proposed crystallisation of the pre 1 July 1983 component in the context of simplified ETP taxation arrangements. While the logical date of crystallisation would be 1 July 2007, IFSA notes that this change will have significant systems implications. We suggest that the Government allow a window for providers to calculate the amount of pre 1 July 1983 prior to (or after) 1 July 2007, with the amount calculated to apply from 1 July 2007.

The issue of crystallisation of the pre 1 July 1983 component is discussed specifically in relation to pensions under *"Payment rules simplified"*.

Removal of Reasonable Benefit Limits (RBL)

We strongly support the removal of RBLs. Abolishing the RBL system will reduce administrative costs for the industry and improve consumer understanding of the system.

We note that with the removal of the RBLs, a number of consequential legislative amendments will be necessary. Two of these are outlined below.

SG Obligations

Amendments will be required to be made to s.19(4) - (7) of the *Superannuation Guarantee (Administration) Act 1992.* These sub-sections effectively allow an employee to 'opt-out' of further SG contributions from their employer, where the employee has benefits in excess of their pension RBL. The purpose of this provision was to allow employees to avoid accumulating superannuation where the end benefit would be taxed on a punitive basis. With the abolition of RBLs from 1 July 2007, this provision is no longer necessary.

However, given that the election is irrevocable (s.19(5)), it may now be necessary to amend the legislation so that an employee is able to revoke the election and thus ensure that their employer is required to make further SG contributions from the date of revocation. Consideration needs to be given to making these amendments as soon as possible (ie. well in advance of 1 July 2007) because, with the removal of tax on super benefits post age 60, and the abolition of RBLs, some employees may now be disadvantaged by not having SG contributions made on their behalf (although we would anticipate most would be compensated by other forms of remuneration).

The ability to revoke a previous election is also relevant with respect to a person's capacity to qualify for a deduction on personal contributions in years in which they are unsupported (ref: s.82AAT(1F) ITAA36).

Protection from creditors in bankruptcy

We note the Government's recent announcement proposing immediate changes to reinforce the trustee in bankruptcy's access to super contributions which have not been made with a genuine retirement income purpose in mind. We also note the proposal to remove RBLs and that the pension RBL is used as a limit on the amount of super benefits which can be protected in the event of bankruptcy.

Given the announced measures, we suggest that the Government give consideration to removing the pension RBL limit on the amount of super benefits which have protection. That is, all assets in super would be protected subject to the proposed contribution clawback provisions. This protection would be provided on the basis that the new contribution rules (under both tax and bankruptcy law) should have the effect of ensuring that super is not exploited for bankruptcy purposes.

Taxation of death benefits

IFSA is keen to ensure that arrangements for the taxation of death benefits are consistent with the overall objective of simplification. Our view is that any requirement for funds to maintain tax components for benefits paid on the death of a member aged 60 or more should be as simple as possible. IFSA has explored a number of methods to address this issue, all of which demonstrate varying degrees of complexity.

Under the current Government proposals, benefits would be tax free only if paid to a dependant (for tax purposes). Funds would need to accommodate cases where benefits of a deceased member over the age of 60 became payable to a non-tax dependant, eg. an adult child, despite the fact that benefits paid to members aged 60 or over prior to death would be tax free. This gives rise to the following administrative issues:

- Funds would need to store exempt and taxable component information for all members, including those over age 60 who no longer rely on these components for taxation purposes;

- Funds would need to be provided with rules to determine how much of each component remains at the time of the death payment;
- Even after a person turns 60, whether in accumulation or pension phase, any rollover to another fund will have to be accompanied by a breakdown into exempt and taxable components.
- If a person has made a partial withdrawal in accumulation phase, for example, rules would need to be developed to establish how much of such a withdrawal was taken from the exempt component and how much from the taxable component.

We consider that the arrangements for the taxation of death benefits could be made less complex. We doubt that these would have a major revenue impact (particularly if it is assumed that strategies will be developed to ensure that benefits which would otherwise be subject to tax upon death are taken tax free after age 60).

In the interests of simplicity and efficiency we ask that the Government consider the following proposals.

<u>Option 1</u>
Allow all death benefits in respect of deceased members over the age of 60 to be paid out tax free, regardless of the dependency status of the beneficiary(s). Taxation arrangements for benefits paid in respect of deceased members under the age of 60 would remain linked to the tax definition of dependant.

<u>Option 2</u>
If option 1 is not acceptable, we propose that all death benefits paid to dependants for SIS purposes should be tax free (this will include adult children). We also propose that the SIS definition be expanded to include ex-spouses. This would ensure consistency with the definition of dependant for tax purposes. While this option would require the maintenance of tax components to account for the payment of benefits to the deceased's estate, it would constitute an improvement in the administrative arrangements for the payment of benefits on death.

Tax Components – individuals aged 60 or over

Should the Government continue to tax death benefits paid to non-dependants in respect of deceased members aged 60 or more, we propose that there be a simple mechanism for maintaining tax components and, particularly for income streams, calculating the reduction in the taxable and tax exempt components (ie. the undeducted purchase price and deductible amounts).

As discussed under *"Payment rules simplified"* below, the translation of allocated and market-linked pensions (term allocated pensions or TAPs) to the new pension standard is IFSA's primary objective with respect to this part of the Plan. To that extent, and because we believe current rules are complex and will be somewhat superfluous for new pensions commencing after age 60, we would welcome the opportunity to discuss the simplification of the tax rules for all pensions (whether commenced from 1 July 2007 or existing).

Irrespective of our translation proposal, if it is assumed that the Government will insist on taxation of death benefits paid to non-dependants post age 60, the following need to be considered:

- tax on pensions and annuities commenced pre 1 July 2007,
- the need to provide flexibility for rollovers and contributions to pensions after 1 July 2007 ie the ability to add amounts directly to the pension phase without the need to commute and take a new pension. In this case any change to components would be calculated and apply from the following 1 July, and
- the re-striking of the exempt component at 1 July 2007 to take into account the pre 1 July 1983 component.

With the above considerations in mind, possible methods for the maintenance of components for members aged 60 and over are outlined below. IFSA would welcome the opportunity to discuss these methods further with Treasury.

1. Maintain the existing taxation component calculation, and drawdown of undeducted purchase price, for pensioners of all ages after recalculating the deductible amount (to include the pre 1 July 1983 component as per our suggestions outlined under *"Payment rules simplified"*) on all pensions as at 1 July 2007. This method would also apply to pensions commenced on or after 1 July 2007.

The current rules in relation to commutation and recommencement of pensions would be used to calculate the new deductible amount in the case of a full rollover or additional contributions. This largely maintains the current rules, which have the disadvantage of not being overly simple or flexible when dealing with pension transfers or accepting new money. However, the advantage of this approach is the avoidance of maintaining two systems to implement the changes.

2. A proportionate approach could be adopted so that any drawdown is deemed to comprise the relevant % of tax exempt and taxable based on the initial purchase price (as adjusted for any additional contributions or rollovers). For example, if a person had a benefit of $100,000 comprising $20,000 tax exempt and $80,000 taxable, any payment would reduce the tax exempt component by 20%. Earnings would be similarly allocated to each tax component (20% to exempt and 80% to taxable).

The advantage of this method is that it allows for a much simpler regime for pensions acquired post 1 July 2007 and, potentially, also existing pensions post age 60. It also readily allows for additional contributions and rollovers to income streams acquired post 1 July 2007 regardless of age.

Extending the new calculation of deductible amount to all pensioners (both new and existing) as at 1 July 2007 would be preferable. This would mean recalculating the tax exempt amount, based on the new tax exempt component as a percentage, for all pensioners at the time components are restruck. The advantage of this approach is its relative simplicity and its application to all pensions, meaning one system could be maintained.

The disadvantage of this approach, for those under age 60, is that it may result in a reduced tax exempt amount for some pensioners as it is not possible to replicate the straight-line approach currently in place. Those pensioners with pre 1 July 1983 component will be less likely to be detrimentally affected where this is added to the deductible amount (refer to the section *"Payment rules simplified"*). Such an approach would tend to favour those drawing greater income amounts whereas those on the current system drawing close to the deductible (and paying little tax) would always have a proportion of the income treated as taxable. Nevertheless, this would only apply until they reached age 60.

Alternatively, method 1 above could apply to those with existing pensions up to age 60. Then, since income will be tax free post age 60, these income streams could be converted to the proportionate model at that point. The disadvantage is that this would require systems and process changes and also a short term situation where two models need to be run. Nevertheless, maintaining two different systems for a short term may be preferable to maintaining the current system for all existing income streams for the next 35+ years.

Whilst additional amounts could not be made into life-time income streams, this tax model could apply to them as well as to account-based income streams.

IFSA would be willing to discuss the above options further with Treasury, perhaps considering a later start date of 1 July 2008. IFSA would not wish to see this issue becoming an impediment to transforming existing APs and TAPs as outlined under *"Payment rules simplified"*.

Restrictions on forms of payment from pensions

IFSA does not understand the policy rationale for proposed changes to the form in which benefits paid from pensions on death can be paid to certain individuals. We can see no reason to put these limitations in place and our strong preference would be to maintain the status quo. The maintenance of the status quo will not upset many of the estate planning (including binding death benefit) arrangements that are now in place.

Clarification of rules in the accumulation phase

We assume that the rules for the payment of benefits in the accumulation phase will remain unchanged (this would be IFSA's preference), though we seek clarification from Treasury on this.

Invalidity pensions paid to those under 60

The Plan states that pensions taken by individuals aged under 60 would generally continue to be taxed under the current arrangements. It is IFSA's view that benefits paid due to permanent incapacity should be treated in the same manner as benefits for over 60s, given that the circumstances for payment are limited and should be designed to compensate for lack of earnings and entitlements at retirement. We therefore propose that invalidity pensions be tax free for all recipients, regardless of their age.

Taxation of lump sum invalidity payments

Currently four criteria need to be met for a person to qualify for the concessional tax treatment under ITAA s.27G:

1. an ETP must be made;
2. that ETP must be made in consequence of the termination of employment of the taxpayer;
3. the termination of employment occurred because of the disability of the taxpayer, where 2 legally qualified medical practitioners have certified that the disability is likely to result in the taxpayer being unable ever to be employed in a capacity for which the taxpayer is reasonably qualified because of education, training or experience; and
4. the termination must have occurred before the 'last retirement date' in relation to the employment.

If all four criteria are met, a formula is applied which results in a portion of the total benefit being paid as a tax free component. Under the proposed rules, from 1 July 2007 this amount would form part of the new exempt component.

IFSA's view is, provided that the four criteria above are met, benefits paid due to permanent incapacity should be treated in the same manner as benefits for over 60s, given that the circumstances for payment are limited and should be designed to compensate for lack of earnings and entitlements at retirement. The *total* benefit in these circumstances should be tax free to the recipient, regardless of their age.

We further propose that criteria (2) and (3) above be amended so that the s.27G provision should apply to the self employed as well as the employed. It should not matter, from an equity perspective, whether the person is employed or self employed. That is, in terms of policy there should be no distinction between employed and self-employed individuals. This was recognised in a recent report of the House of Representatives Standing Committee on Economics, Finance and Public Administration. In that report, entitled "Improving the superannuation savings of people under 40", at paragraph 6.29, the Committee recommended:

The committee recommends the Government align the tax treatment of invalidity payments of the incorporated and unincorporated self employed.

To rectify this problem, IFSA suggests the addition of the words "or self employment" after all occurrences of the word "employment" in s.27G. If this solution does not work (because, for example, there is no definition of 'self employment' in the ITAA), then it may be necessary to insert a definition, or link s.27G with the definition of 'eligible person' in s.82AAS(2).

2 PAYMENT RULES SIMPLIFIED

IFSA supports the Government's objectives of increased flexibility and simplicity under the proposed simplified payment rules outlined in Chapter 3 of the Plan. Our proposals outlined below are in keeping with these objectives. We consider that the issues addressed below are critical in allowing retirees to effectively plan for their retirement and for this reason we urge the Government to clarify its position on these rules as soon as possible.

Percentage-based drawdowns

IFSA supports a move to the use of percentage-based drawdown factors as a significant simplification of the current Pension Valuation Factor (PVFs) model for consumers. The suggested percentages outlined in the Plan being based on the average of the PVFs for allocated pensions, provides a reasonable basis for setting the new minimum income drawdown amounts.

Translating allocated and market linked products to the new regime by legislation

The current Plan suggests that existing account-based products (being allocated and market linked/TAP products) will remain unchanged and be deemed to comply with the new rules. This would create new classes of legacy products for the industry as well as complexity and potential cost for consumers.

IFSA believes there is a strong case for legislation which would adjust the rules to provide a simple, and seamless, transition for consumers to products closely matching the new minimum pension standards. This will remove complexities for consumers, advisers and funds and should minimise costs over the medium to long term.

Allocated pensions (APs), market linked complying income streams (TAPs) and the new minimum pensions allow consumers flexibility in choosing the income they will draw, subject to a minimum (and for existing APs and TAPs subject to a maximum). Under IFSA's proposals the legislation would provide that the existing requirements for APs and TAPs would be replaced with new standards closely reflecting the new minimum pension rules. This would not have any material impact on the amount a pension member wished to draw.

Under this approach, the new standards would apply without requiring the creation of a new interest.

The Government would be able to present these proposals as a major simplification enhancement to its Plan.

Further details relating to allocated and market linked (TAP) products are provided below.

1. Allocated pensions

Allocated pensions are the largest type of retirement income stream with $55.5 billion FUM.[1]

While we would anticipate that there would be no legislative impediment to AP holders commuting and purchasing a 'new' pension, it would be a time-consuming and costly exercise for consumers, advisers and funds to process ad hoc commutation and re-purchase requests. This would involve:

- Consumers seeking advice;
- Planners preparing SOAs;
- Consumers applying for redemptions;
- Funds processing the redemption;

[1] Source: Plan for Life Research, *MINDER—Market Intelligence Decision Maker's Resource,* Issue 447, July 2006

- Consumers reading a PDS (product disclosure statement) and completing the attached application even if they are with the same provider and otherwise have the same terms and conditions;
- Consumers most likely incurring a buy/sell spread cost; and
- Funds then establishing the new interest.

IFSA's proposed translation legislation would remove the need for the above process, thus avoiding unnecessary cost for both consumers and funds.

The legislation in relation to APs would:

1. Remove maximum payments; and
2. Replace the current minimum PVFs with those applicable to the new minimum pension standard.

As indicated above, IFSA supports the minimum payments being expressed as a percentage of the account balance from a simplification perspective.

In IFSA's view, this would represent an enhancement to the existing terms and conditions of allocated pensions.

2. Market linked income streams (TAPs)

TAP providers currently have about $0.74 billion of FUM, representing 1.1% of total funds in the income stream market[2] (this does not include TAPs paid from self-managed superannuation funds).

Given the small size of the market and the fact that TAPs will have only existed as a marketable product for less than 3 years, IFSA strongly recommends that steps be taken to ensure that TAPs do not become a legacy problem.

Under IFSA's proposals, the legislation would make TAPs subject to the new minimum payment rules with a restriction placed on the maximum amount of income that could be taken from the product in a given year. The amendments would remove the payment term and factors. The maximum could be expressed as a specified percentage of the minimum required payment (for example, 200% of the minimum). These products would continue to qualify for the 50% assets test exemption.

IFSA believes TAPs could then be run efficiently and cost effectively on systems designed for the new minimum pension standards with negligible disruption to consumers.

The legislation would represent a solution to the problem of TAPs becoming a legacy product.

The legislation in relation to TAPs would:

1. Reduce minimum payments to those of the new pension standard, expressed as a percentage of the account balance;
2. Impose a new set of maximum payments to limit access to capital,
3. Maintain the continuing restrictions on commutation; and
4. Remove the term, although the investor could effectively adopt a drawdown pattern which lasts to a late age eg. 95 or 100 depending upon how long maximum limits were imposed.

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"Guaranteed" income streams

Lifetime income streams

Lifetime pensions and annuities are mortality risk based products. There is usually no scope for altering payment terms for these products and the Government has already announced that they will be accepted as meeting the new minimum pension standard.

[2] Source: Plan for Life Research, *Allocated Pensions & Term Allocated Pensions Report,* Issue 55, May 2006.

Life expectancy, nil RCV fixed term complying annuities and pensions

Term certain (no RCV) pensions and annuities represent over $6 billion of funds under management in the income stream market.[3]

In contrast to APs and TAPs, guaranteed income streams are not account-based or market-linked products where the investment risk is borne by the investor rather than the trustee or life company (using actuarial and business risk methodologies). This means that capital is exchanged for a guaranteed amount of income over the relevant period. In order to insure this guarantee, the provider must maintain sufficient capital to meet ongoing liabilities in moving markets and economic circumstances. For these reasons, product transition rules are not needed or viable for guaranteed income payments.

Commutability of complying income streams

The proposed seamless transfer to the new pension rules should substantially address the needs of investors in APs and TAPs and deal with the legacy problems of the providers of those products. Accordingly, IFSA considers that this proposal should be an essential component of the Government's proposed simplification reforms.

However, if IFSA's proposal to transform TAPs is not adopted or is adopted but does not address particular investors' needs, then IFSA members are of the view that the Government should provide a limited commutation window (under both SIS and Social Security legislation) to allow members to commute their benefits without penalty. This is particularly the case for individuals with TAPs who have only very recently entered into a complying income stream developed specifically to give access to concessions not otherwise available to account-based products. The TAP product is non-commutable, restricts access to capital and does not have the advantage of the provider bearing any investment risk ie. there is no income guarantee, nor assets set aside to allow for such a guarantee.

IFSA believes that there are a number of commutation options available in this eventuality and we would be very eager to discuss these further with Treasury. We have outlined one possible approach below.

IFSA proposes that TAPs purchased on or after 20 September 2004 could be commutable during a limited 2 year window without penalty under SIS and Social Security legislation. However, if the Government has difficulty allowing only a segment of complying product holders (ie. TAP members) the opportunity to commute, then this approach could be extended to guaranteed complying income streams (subject to trust or contractual conditions).

The period of 2 years is suggested because not all retirees will become immediately aware of the potential relevance of the 1 July 2007 changes to their own circumstances nor will they act immediately after having become aware. Further, while advice may be obtained during the course of an income year often the least disruptive time for a retiree to alter their income stream arrangements is around the end of an income year (having regard to possible pro-rata income payment requirements and various other considerations).

Drawing a line is always problematic. However, a date of 20 September 2004 delivers a pragmatic outcome for the following reasons:

1. The amount of complying annuity and pension business written since that date has been much lower than prior to that date so there has not been a large detriment to the revenue and any prudential risk (discussed below) would be contained to a manageable level;
2. The members have enjoyed only a limited (by 2007) 3 year access to higher social security payments; and
3. It allows recent members a choice to re-arrange their affairs.

[3] This includes both complying and non-complying income streams.
Source: Plan for Life Research, *Immediate Annuity Product and Rate Report,* Issue 47, May 2006.

IFSA considers that there are sound policy reasons for not, in any circumstance, extending the limited commutation facility to complying income stream products commenced prior to 20 September 2004. These include the prudential risk that if a large number of recipients chose to commute over a short time frame as a result of a change of Government policy, life companies and affected superannuation funds would have to rapidly arrange sufficient liquidity for this to happen. While A-rated life companies would have the capital and time to arrange sufficient liquidity cover, the Government and APRA need to consider whether this would have prudential consequences in any part of the industry. We are therefore of the strong view that the penalties for commutation that currently exist in the Social Security law should be retained for pre 20 September 2004 complying products.

Social Security income test arrangements

While the Treasury consultation paper addresses changes with regard to the social security assets test in its application to retirement income streams, it is unclear how the new minimum pension will be treated under the income test. The current income test provides an allowance for the return of capital invested in an income stream. From 1 July 2007, it will not be possible to distinguish 'income payments' from 'lump sum' or capital withdrawals.

IFSA believes there are sound policy reasons to ensure that the income test arrangements continue to provide some form of incentive for retirees to purchase income stream products.

Consideration of the possible options for the income test must also take into account existing income stream recipients so as to avoid complex and costly grandfathering arrangements wherever possible.

With these critical issues in mind, it is considered that the best option would be to continue the current income test treatment for superannuation-based income stream products. For this purpose, it may be necessary to define a maximum income for income test purposes. We believe that for APs this maximum could be determined by Centrelink and DVA using the existing maximum PVFs or adopting a percentage-based approach similar to that suggested for TAP maximums that provides a marginally better outcome for existing AP holders.

For TAPs, the actual income would be used as currently applies.

Such an approach would ensure that existing members are no worse off and, more importantly, facilitates IFSA's proposal for a clean transition for current APs and TAPs to the new model as suggested above.

Undeducted purchase price, deductible amounts – pre 1 July 1983 component

It is IFSA's view that the pre 1 July 1983 component should be calculated effectively at 1 July 2007 for inclusion in the tax exempt component of all accumulation and all pension and superannuation-like annuity products. Providers would be allowed an administrative timeframe to crystallise for accumulation arrangements and pensions post age 60 as suggested above under "*Crystallisation of pre 1 July 1983 component"*).

In contrast to the Plan, which only contemplates including the pre 1 July 1983 amount in the tax exempt component for new income streams, IFSA's approach provides those in non-commutable pension arrangements parity with those in commutable products who can choose to refresh their tax exempt component by commuting and rolling to a new minimum pension product. To ensure that no one with an existing income stream is worse off, we would suggest that the crystallised pre 1 July 1983 component simply be added to the deductible amount (by dividing the pre '83 component by the reduced relevant number and adding this value to the current annual deductible amount).

Removal of compulsory cashing

We strongly support the removal of the compulsory cashing payment rules for individuals aged 65 and over. We also appreciate the Government's prompt announcement that the removal of these rules would be brought forward to 10 May 2006. This will ensure that individuals reaching the age of 65 or retiring in the period up to 1 July 2007 can leave their benefits in the super system until the rules are clear and in anticipation of advantages under the new tax regime, including more flexible payment rules that will apply from that date.

Minimum pension standards – amounts left over

The Plan currently includes as a standard that there must be "No provision to be made for an amount to be left over when the pension ceases". We are somewhat concerned with the intent implicit in this statement. Our understanding is that the new regime is intended to allow funds and registered organisations (via ETP annuities) the flexibility to develop products suitable to a wide variety of needs in the retiree market. This would include providing, for example, limited guarantees for fixed terms, amongst other features if applicable.

An example of such products in the current regime includes RCV ETP annuities. These pay a guaranteed income and have a guaranteed RCV at the end of the term. It should be possible under the proposed regime to design products with these features (whether specifically as RCV type annuities or via other models eg. constructed portfolios).

IFSA accepts that it is reasonable to impose conditions requiring income stream providers to pay the minimum pension based on the amount of assets used to support the income stream. That is, it would not be appropriate for amounts to be set aside or otherwise separated from the pension account in order to circumvent the minimum payment requirements.

However, if this standard is intended to prevent providers from explicitly operating income streams with features that may include a guaranteed amount after the expiry of specified periods, we do not support it. We would urge Government to ensure that the rules do not preclude the ability for providers to specifically design products where there may be "amounts" remaining provided that the product pays out at least a minimum level of income relative to the investment (be this account based, or perhaps as a [varying] percentage of initial purchase price or as a percentage of units at purchase date etc). An individual could clearly orchestrate a range of such outcomes given that the Plan simply requires minimum drawdowns, does not impose a maximum and does not force an income stream to end.

In summary, IFSA believes that this type of limitation should not be a preclusive condition provided that the minimum income payment is met each year whether the income stream is account based or otherwise.

Income streams purchased with non-superannuation money

Annuities purchased with non-superannuation moneys currently represent $8,190 million of funds under management or 12% of the income streams market. They may be lifetime annuities (with or without RCVs), or short or long term fixed term annuities (with or without RCVs). Lifetime and fixed term annuities may be 100% or 50% assets test exempt (depending on date of purchase) if they meet the other requirements of s.9A or 9B of the *Social Security Act 1991.*

It is IFSA's expectation that lifetime and fixed term annuities purchased prior to 20 September 2007 which are 'complying' for social security purposes will retain their 100%/50% assets test exemption.

IFSA has assumed that the changes to the minimum pension standards from 1 July 2007 only apply to income streams purchased with superannuation money. Annuities purchased with non super money may continue to be offered (with or without RCVs) after 1 July 2007 with the existing tax free status of fund earnings, but the assessable income would continue to be taxable in the recipient's hands and no concessional age pension assets test would apply.

Transition to Retirement

IFSA supports the Government's plan to retain the ability for individuals to access their superannuation in their transition to retirement as a non-commutable income stream. For this purpose we agree that a cap is required. In line with our proposals to avoid grandfathering arrangements where possible, IFSA suggests that the methodology for determining the maximum, as set out above under *"Translating allocated and market linked products to the new regime by legislation"*, apply to both existing and new transition to retirement income streams (TAPs and APs).

3 SIMPLIFIED CONTRIBUTION RULES

In the context of the removal of RBLs, IFSA recognises the need for contribution limits which are aimed at appropriately targeting the concessionality of the super system. IFSA's proposals outlined below in relation to Chapter 4 of the Plan are designed to ensure integrity of the contribution limits and also to ensure that the administration arrangements for the contribution caps are not overly complex or costly.

Contribution cap integrity

Under the plan, the unlimited deduction on concessional contributions as well as the ability to leave excess concessional (deductible) contributions in the fund effectively allows wealthier individuals to circumvent the contribution caps without adverse consequences. Taxing such contributions at the top marginal rate will not provide an adequate deterrent for some high income earning individuals, who would benefit from the arbitrage opportunities involved in making large deductible contributions, on which earnings will be taxed at the fund tax rate (maximum 15%) in future years, and where benefits can ultimately be drawn out tax free after age 60.

Because it appears the Plan intends that contributions in excess of the concessional cap will be deductible, some additional control or penalty would be required to make the system more robust and less open to arbitrage. Possible options to ensure greater integrity of the contribution caps are outline below. As proposed above under *"Administration of the contribution caps" below,* breaches of the caps under all of these options would be dealt with as a matter primarily between the ATO and the individual.

<u>Option 1 – Impose penalty taxes on excess UDCs and DCs</u>
In order to minimise opportunities for arbitrage, IFSA suggests that contributions made above the UDC and DC caps should be subject to higher punitive penalty rates of tax designed to discourage individuals from intentionally exceeding either cap. Under this approach, penalty tax rates would apply to excess UDCs as well as DCs and no refunds of excess UDCs (or attributed earnings) or payment of additional earnings tax would be required.

While discouraging individuals from exceeding the caps, a further advantage of this approach is its simplicity and the reduced administrative burden for both funds and the ATO. It is also relatively simple for fund members to understand.

<u>Option 2 – Refund all excess contributions (above both caps)</u>
An alternative approach would be to require refunds above both caps. This could involve applying a similar approach to deductible contributions as that proposed for UDCs under the Plan by refunding the excess, and notional earnings, after imposing tax at 31.5% (46.5% including the effect of contributions tax) on the excess deductible contributions. In effect, the outcome would be largely tax neutral and hence reduce active arbitrage behaviour.

Employers would still be able to obtain a deduction for excess amounts of deductible contributions, if applicable, but the individual would not benefit from any differential treatment as between super and receiving salary.

<u>Option 3 – Impose a higher penalty tax on excess deductible contributions only</u>
A further alternative would be to apply a higher punitive penalty rate of tax to excess deductible contributions only.

Under this option, excess undeducted contributions would be returned to the member and earnings (calculated using a proxy) on these amounts would be subject to tax at the highest marginal rate, under the arrangements outlined below under *"Administration of the contribution caps"*.

Option 4 – Impose a maximum deductible contribution limit
A fourth option would be a move back to a "maximum deductible contribution" base for each contributor. This approach would also tend to reduce opportunities and activities aimed at defeating the fundamental purpose of the caps particularly by related parties. The existing law appears to be well understood by employers and contains long-standing related-party quarantine rules. We consider that this would not impose undue obligations on employers as they are currently required to administer deductible contribution limits for employees through the aged-based deduction limits. We note that the replacement of the aged-based limits with a single limit for all individuals should help to reduce the administrative obligations for employers.

Under this approach, it may not be necessary to ensure funds hold TFNs in respect of members receiving employer (deductible) contributions as there would not be a need for the ATO to assess individuals against the deductible contribution cap.

One disadvantage of this option is that it would not completely remove opportunities for arbitrage. Even with the imposition of a limit on deductions, employers and employees would still be able to enter into arrangements in circumstances where the employer was prepared to forego a deduction or where the employee agreed to bear the cost of the denial of a deduction for contributions made above the limit. Therefore, if the Government were to adopt this approach, there may be a need for anti-avoidance provisions to prevent such behaviours.

While breaches of the deductible contribution cap would primarily be controlled by the deduction limit, breaches of the undeducted contribution cap would be dealt with as a matter primarily between the ATO and the individual under the arrangements outlined below under *"Administration of the contribution caps"*.

Note: The imposition of a maximum deductible contribution limit could also be considered in conjunction with other options as an additional control.

Option 5 – Global cap
IFSA has given a great deal of consideration to imposing a combined cap which would apply to both deductible and undeducted contributions. Under such an approach, contributions above the 'deductible', or concessional cap could reduce the amount available under the UDC cap until an overall (global) cap is breached. Excesses above the global cap would be refunded as would earnings on the excess. There are a number of possible ways of operating such a model, all of which seem overly complex and would not completely remove the potential for arbitrage.

This approach is very complicated, particularly when taking into account the 3 year bring-forward arrangements. It would prove to be difficult to explain to members and we believe difficult to monitor. The longer the timeframe (as a result of the 3 year bring forward arrangements) the more difficult the assessment and control process will be.

Apart from the difficulty with explaining the method to members and advisers, we can anticipate that fund administration staff would find it very difficult to provide affected clients with meaningful information about how they were tracking against the contribution limit. Similarly, we would think ATO staff would struggle to provide an accurate picture at any given point in time. For these reasons we do not consider a global cap to be as effective as other options.

Administration of the contribution caps

A member-centric approach

In the interests of simplicity, IFSA's view is that breaches of the post-tax and deductible contribution caps should be matters primarily dealt with between the member and the ATO. A member-centric approach will avoid the complexity and inefficiency associated with the surcharge system which involved tax liabilities being transferred from fund to fund and tax, in many cases, not being paid until several years after the contribution was made. In this regard, it is noted that, due to the $450,000 averaging provision, assessments on undeducted contributions will not be made, in the main, until up to 4 years after the initial contribution. Account mobility and the continued rationalisation of funds would create a complex web if the funds were the primary route to finding and assessing individual accounts.

A member-centric approach will also ensure that funds are not inappropriately expected to subsidise those who exceed the standard limits, or to build expensive tracking systems and incur potentially significant re-work costs. By assessing the individual the ATO will not have to apportion assessment between funds and should be able to more efficiently track compliance.. Hence individual assessment will create efficiencies for the ATO.
IFSA proposes the following that are consistent with a member-centric approach:

Contribution information for ATO

<u>Option 1</u>
IFSA proposes that the information relating to the caps be administered on a self-assessment basis. Under this approach, a member would declare the amount of both post-tax and deductible contributions made on their behalf each year in their tax return. For employees, information about the amount of deductible contributions could be shown on their PAYG Statements (the document formerly known as a group certificate). Tax penalties and refunds would then apply in accordance with the proposals set out below.

Effectively, this aspect minimises the annual reporting requirements that would otherwise need to be imposed on funds (above and beyond what is currently captured for co-contribution purposes).

<u>Option 2</u>
An alternative approach would be for the ATO to assess a member's position regarding the caps based on the information reported to the ATO by superannuation funds in member contribution statements. The ATO would then advise the member of any excess contributions and applicable penalty tax.

Application of penalties for cap breaches

Under both the above options, the ATO would advise the member of any excess contributions, applicable penalty tax and amounts to be refunded to the member if applicable (refer to IFSA's proposals under the section *"Contribution cap integrity"* above).

IFSA's view is that regardless of the options adopted to ensure the caps operate effectively, the member must ultimately be the entity liable for any penalty taxes and ensuring that tax notices are submitted to the appropriate fund.

Depending on the options adopted for managing the caps, on presentation to the fund of ATO documentation, penalty taxes, excess UDCs and deductible contributions together with related gross (pre-tax) earnings (as determined by a set formula and stipulated on the ATO documentation) would be paid from the fund of the member's choice (provided an adequate balance is available). The member would be required to pay the applicable taxes to the ATO.

Funds would report refunds as well as withdrawals made for the purpose of paying penalty taxes to the ATO.

Note: Under IFSA's Option 1 outlined under *"Contribution Cap Integrity"* above, it may be appropriate to enable funds to pay a member's assessed tax liability directly to the ATO upon request given that no amounts would be refunded to the member.

Calculating tax on earnings (where applicable)

In determining the tax on excess post-tax contributions, it is impossible or, at best, extremely complex and costly, to calculate actual gross earnings on excess amounts given the ability for members to move around the system, to choose different investment options and to add contributions and withdraw lump sums at any time (subject to eligibility).

Superannuation funds do not currently calculate and report earnings on contributions in isolation. Nor do funds calculate or provide members with an internal rate of return for members' accounts based on the particular cash flows of the account over a given period.

Account information is, however, provided to members on their statements (at least annually) detailing opening/closing balances and any change ($ amount) in investment value for the period. These statements generally also display any contributions/inbound rollovers and withdrawals/outbound rollovers made within the period. Given these factors using the opening and closing balance of the member's account over a period to determine the earnings rate would neither be satisfactory nor correct.

Attributing earnings to particular contributions would be extremely difficult for funds to implement given the number of investment options members can select, and the ability to switch in and out of investments and rollover between funds.

The example below outlines a simple client scenario:

John Client's account summary (period 1 July 2007 – 30 June 2008)

At opening balance date, John is invested in one option, the Conservative Option. Undeducted contributions are invested in the Balanced Option, as is his rollover at 1 September.

Opening balance (01/07/2007)	$250,000
Undeducted conts – 01/07/2007	+$150,000
UDC Rollover (inbound) – 01/09/2007	+$100,000
UDC Withdrawal/Rollover (outbound) – 01/03/2008	-$350,000
Switch of $100,000 into 2 investment options (50% Diversified : 50% Cash)	
Closing balance (30/06/2007)	$165,000

Assuming John has made $50,000 excess contributions (he has also made contributions to other funds in the year), it becomes very difficult for the fund to determine earnings on these excess contributions. Based on opening/closing account balance John's return is -34%, but taking into account his cash flows for the year his return is 10%. However, focusing on his actual investment(s) another rate of return is generated. The difficulty for funds in accurately attributing earnings to particular contributions is evident.

The location of the excess contributions at year end, and at the time of reporting contributions for the year, may also be uncertain. Funds may not be aware they hold contributions/earnings on contributions to which excess tax is to be applied until this information is reported back to the fund by the ATO via the member (well after the contribution is made).

To ensure integrity of the system the ultimate method used to calculate earnings on excessive contributions must be consistent and fair across all funds. If it is left to funds to implement their own reasonable methodology the ATO would undoubtedly want to check/validate the method used. This may prove to be overly time-consuming given the number of cases likely to occur.

IFSA proposes that a proxy for earnings on excess contributions be used as a basis for calculating penalty tax. Our preferred proxy would be a rate consistent with the long-term bond rate. This would ensure that a member would not be refunded excessive amounts of earnings in respect of contributions made above the UDC cap. An alternative would be to use the General Interest Charge but this is not a preferred option as it is a harsher penalty, particularly in times of volatile economic markets or market downturns.

The amount would be calculated and communicated to the member by the ATO via the process outlined above.

Contributions splitting

A mechanism would be required to ensure contributions subject to spouse-splitting with a spouse could be assessed and if necessary, subjected to excess penalty tax and/or recovered from the member's or the spouse's account. One option to deal with this is to require members to include details of a split in their tax return. The ATO could then assess the spouse for any amount that is split in excess of the cap.

Depending upon the approach to managing the contribution caps, the Government may need to develop legislative provisions which would provide the ATO with authority to:

- compel a fund to refund amounts deposited in the fund in the form of a contributions-splitting ETP, or
- allow an assessment notice for penalty taxes to be submitted by the member (or re-issued by the ATO) to the spouse's superannuation fund

It should be noted that the fund may be unaware that this amount represents a contributions splitting ETP – it may appear to be a 'normal' ETP to the receiving fund. This would be the case where a member splits 100% of their undeducted contributions with a spouse, and leaves either a nil balance in their original fund or an insufficient amount to cover the refund. As indicated above, where 85% of a person's deductible contributions are split to a spouse, the ATO would, in some cases, require additional legislative authority to allow it to recoup the tax from the spouse's account.

Issues specific to deductible contributions

IFSA is very supportive of the Government's plan to allow deductible contributions to be made in respect of employees and the self-employed to age 75. We also support the replacement of the age-based deduction limits with a single limit of $50,000 per year and the proposed transitional arrangements which would allow individuals aged 50 and over to make deductible contributions of up to $100,000 per year until 2011/12. We suggest that the Government review the level of the deductible contribution cap in 2012/13 following the conclusion of these arrangements, to ensure the cap is maintained at an appropriate level.

Section 82AAT notice issues

IFSA considers that the 2006 budget proposals (as they relate to superannuation contribution caps) mean that changes will be required to the current mechanisms adopted in taxation law in respect of member deductible contributions (in particular sections 82AAS and 82AAT of the *Income Tax Assessment Act 1936*).

The effect of a notice under sec 82AAT (1A) is that the contribution amount covered by the notice ceases to be an undeducted contribution and becomes a deductible contribution.

Under the current tax law provisions there is no time limit within which a member must lodge a notice under s.82AAT(1A) or a variation notice under s.82AAT (1C) (subject to them still being a member of the fund). Under the present arrangements funds regularly receive notices that relate to tax years 3, 4 or 5 years ago (in some extreme case notices have been received relating to contributions made up to 10 years ago).

IFSA is of the view that continuation of the current tax law arrangements for the lodgement of s.82AAT notices would greatly complicate the administration of the proposed contribution caps (both deductible and undeducted).

Continuation of the current rules would give rise to problems in the following situations:

- A member lodges an 82AAT notice several years after the contributions were made (ATO would not be able to monitor caps 'real time', amended assessments would be required - similar problems may arise as those experienced under the surcharge regime).

- A member appears to have exceeded the undeducted contribution cap but is yet to lodge their 82AAT notice – the effect of which will take their undeducted contributions below the undeducted contribution cap.

- A member lodges a variation notice after the ATO has made an assessment in relation to the taxpayer's deductible and undeducted caps.

In order to facilitate administration of contribution caps on a 'current year' basis (rather than having to re-assess members in respect of prior tax years), IFSA is strongly of the view that:

- time limits should be introduced in respect of members giving 82AAT notices; and
- restrictions should be placed on varying 82AAT notices.

<u>Option 1. Cut-off date for the lodgement of an 82AAT notice</u>
If the broader changes to the management of personal deductible contributions at Option 2 are not taken up, then as a minimum requirement IFSA consider that a cut-off date for the lodgement of 82AAT notices needs to be introduced. Whilst various suggestions have been considered in respect of an appropriate cut-off date, IFSA's preferred cut-off date would be the 30 September following the 30 June year end. For example – for contributions made in the year ended 30 June 2007, the member would have until 30 September 2007 to lodge an 82AAT notice. This would not preclude the member from providing notices earlier if they so wish – for example notices could be made with each contribution.

The reasoning behind the 30 September cut-off date is as follows:

- This date will provide time for funds to process and collate all of the 82AAT notices in time for the Member Contribution Statement (MCS) reporting that funds are required to provide to the ATO by 31 October each year. It is anticipated that the MCS reporting will be used by the ATO as the primary source of information for monitoring of contribution caps at member level.

- The 30 September date also means that the 82AAT information will be reported in time for inclusion in both the member's personal tax return and the superannuation fund tax return. This will remove the complexities that are currently experienced by funds in effecting a cut-off in respect of 82AAT notices for superannuation fund tax return purposes. The inclusion of amounts in current year returns for both the fund and the member will also assist the ATO with 'real time' administration of taxes at both the fund level and personal tax level.

Under this approach, no variations beyond the cut-off date would be allowed.

One of the main problems with the current process is that a person's status may change throughout the year from eligible to ineligible. The fundamental difficulty with the current section 82AAS is that individuals do not know whether they pass the 10% test until after year end. This is the main cause of delays in members lodging 82AAT notices with funds.

Perhaps the policy could be reviewed to allow deductions in respect of part-years where an individual meets the self-employed eligible person test but subsequently moves into a master-servant employment relationship.

<u>Option 2. Removal of eligible person/10% test</u>
As an alternative to the current 82AAT process, IFSA proposes that the Government consider removing the eligible person test set down in s.82AAS of the *Income Tax Assessment Act 1936*.

Currently in order to claim a personal tax deduction for contributions to a superannuation fund an individual needs to be an "eligible person". This term is defined in s.82AAS(3) and essentially means that the person derives less than 10% of their assessable income from employment. In paragraph 4.4.2 of the Plan it is suggested that this will be simplified by determining eligibility for a personal deduction on the amount of assessable income and reportable fringe benefits attributable to the member's employment (similar to the rules for the co-contribution).. An amendment such as this would allow the test to be applied more simply; however it does not solve the problems created by this rule.

The operation of the eligible person test often causes delays in members lodging their 82AAT notices. Often a member will not know whether they qualify as an 'eligible person' and are able to lodge an 82AAT notice in a particular tax year until they have visited their accountant, usually after year end, and had their personal tax return prepared for that tax year. This lack of certainty for members during the financial year needs to be resolved, especially as a result of the increased level of reporting on contributions funds will be required to undertake under the Plan.

Individuals who are fully engaged in employment can access the $50,000 deductible contribution cap by asking their employer to "salary sacrifice". That is, salary is forgone in exchange for additional superannuation contributions. Hence, those fully employed people who are able to salary sacrifice (many are not) can potentially access the full $50,000 limit. The proposed limit on deductible contributions made by fully self-employed persons is also now a flat $50,000 before there are consequences for exceeding the cap. Excess deductible contributions are to be taxed at the top marginal rate; however there appears to be no limit on deductions.

One way to solve the problems created by section 82AAS would be to remove the complex requirements of the 10% test altogether, allowing both employed and self-employed persons access to a personal deduction. This may require a different approach to the contribution caps than proposed in the Plan. For example, as proposed in option 4 under *"Contribution cap integrity",* the concept of a maximum annual deduction limit could be maintained per contributor, per member or per related party (ie. $50,000).

On the basis of the above, 82AAT notices to funds would arguably be obsolete, and further legislative change could be considered such that all member contributions could be deemed to be deductible and hence taxable unless the member lodges a notice with the fund to advise otherwise (the notice could be required to be lodged with the fund within specified time limits).

If a maximum deductible contribution limit was imposed in respect of members, the ATO would deny a deduction above that limit and issue a notice to that effect to the member. The member could submit the notice to the relevant fund which would convert member taxable contributions to undeducted and reclaim the contributions tax. If there are insufficient taxable member contributions because the member has split, rolled over or has exited, the notice to convert back to undeducted could be executed.

IFSA recognises that there may be options in addition to those proposed above, which could include a greater level of involvement between the fund member and the ATO in claiming deductions. We would welcome the opportunity for further consultation on these issues.

Issues specific to undeducted contributions

Immediate impact of the cap on undeducted contributions

The Plan states that a cap of $150,000 per year would apply to undeducted contributions made from 9 May 2006. We acknowledge that there are sound policy reasons for the introduction of a cap on undeducted contributions given the removal of end-benefits tax and RBLs. However, IFSA believes that there is a need to provide some form of transitional relief from the cap on undeducted contributions. We are concerned about the impact the application of the undeducted contribution (UDC) cap has on superannuation fund members with legitimate arrangements in place prior to 9 May 2006 to make contributions above the cap. This is of particular concern for individuals nearing retirement.

Further, many of the rules surrounding the UDC cap and the mechanics of the averaging provisions were initially not clear and it is only recently that the Government has further clarified some of these issues.

<u>Delaying the commencement of the UDC cap</u>
We propose that the commencement of the UDC cap be delayed until the 2006/07 financial year. This will give individuals the benefit of not inadvertently triggering the commencement of a 3 year average cap in the 2005/06 financial year (by making a contribution of more than $150,000) under

which they may be prevented from making further contributions until 1 July 2008 (subject to the work test arrangements).

Should the Government be inclined to provide this relief but with additional restrictions, we believe that it would be appropriate to consider a flexible approach to the ‘averaging’ rule in the initial phase of the regime by allowing total undeducted contributions of up to $600,000 to 30 June 2009.

The contribution work test

IFSA has previously suggested that the Government consider removing the work test applying to contributions made by individuals aged 65 and over as a means of providing relief from the UDC cap. We recognise, however, that the work test is consistent with the Government’s policy of encouraging workforce participation of mature aged workers.

Nevertheless, we note that if the Government wishes to maintain the contribution work test, there would be difficulties for individuals nearing retirement who had intended to contribute amounts above the annual cap if they are unable to make use of the 3 year averaging arrangements.

IFSA is therefore of the view that the Government should, in addition to a delayed start date for the UDC cap, consider allowing individuals to make use of the averaging arrangements with an assessment against the contribution work test applying only at the time the contribution is made. We note that, while this approach facilitates averaging to occur in the year of retirement, it does not negate the operation of the work test: it continues to apply at the time of contribution. In other words, it applies at a single point in time, as is the case under current law.

At the very least, we propose that this be the case for at least a transitional period, for example, up until 30 June 2009.

Although not preferred by IFSA, an alternative to the above and in addition to a delayed start date for the UDC cap, the Government could allow people aged 63 or over on 10 May 2006, a maximum cap of $450,000 in 2006/07, as a transitional measure and then a $150,000 annual cap for financial years thereafter (subject to eligibility under the work test). Under this approach the averaging arrangements would be subject to the work test in the manner described in the website fact sheet, so that an individual would not be able to make use of the averaging arrangements when the work test is not met in years following the contribution. This approach would accommodate those who were about to put into place their retirement arrangements but had not gone through with their plans because of the new rules and subsequent uncertainty about their application in some circumstances.

IFSA appreciates that there are several alternatives to the options proposed above, and we are happy to discuss these further with Treasury.

2005/06 Member Contribution Statement (MCS) reporting

The reports that funds currently send to the ATO (in the form of member contribution statements) do not currently provide a breakdown of each contribution made and the date on which it was made. This may make it difficult to identify undeducted contributions that were made pre/post 9 May 2006.

We note that a delay in the commencement of the UDC cap until 1 July 2006, as proposed above would avoid such difficulties.

However, if the Government proceeds with the 9 May 2006 commencement as announced, IFSA’s preference is that any additional reporting that may be required for the transitional 2005/06 year only be required in respect of members who made undeducted contributions in excess of $150,000 in that year.

Proposed exemptions from the caps

To ensure that access to the concessionally taxed superannuation environment is appropriately managed, the imposition of a cap of $150,000 per annum on the amount of after-tax contributions that a can be made in a superannuation fund is defensible in light of the removal of reasonable benefit limits.

The Plan mentions the potential scope for certain exemptions to the cap. The example given in the Plan is the CGT exempt component from the sale of a small business. We note that this component is not an undeducted contribution (although it is tax free in the same way as a UDC) and we would therefore have assumed that this should have been excluded from the caps for this very reason.

IFSA considers that the Government should allow for certain other exemptions from the cap to ensure the new contribution arrangements are as equitable as possible. IFSA recognises that the need to provide relief from the UDC cap must be balanced against revenue constraints and the need to minimise complexity. With this in mind, our view is that individuals should be afforded relief from the cap in the following limited circumstances:

- individuals in receipt of disability/compensation payments;
- individuals transferring pensions benefits from overseas funds; and
- small business owners who contribute the proceeds of a sale.

Providing the exemption for each of these groups is dependent upon different reasons as outlined below.

1. Disability/compensation payments

IFSA believes that these members of the community who have already suffered greatly through their injuries should be afforded some form of relief from the UDC cap. IFSA proposes that relief from the UDC cap be provided to allow individuals in receipt of such payments to fund cost of care and living expenses through superannuation income streams.

As an alternative to a full exemption, a limit on such contributions could be introduced. The operation of this limit could be based on the number of years until normal retirement (i.e. age 65) multiplied by the $150,000 annual UDC limit.

To avoid potential scope for abuse, compensation payments for this purpose could be specifically defined to only include court-based settlements, payments authorised from a state-based workers compensation authority or those approved by the regulator (similar to release on compassionate grounds).

2. Transfers from an overseas pension fund

With the current 1 million of Australian expatriates living overseas and a migration rate of 10,000 per year from the UK, it is important that individuals retain the ability to make transfers from overseas superannuation funds.

We note that recent Government policy has removed impediments to transferring retirement savings from overseas. For example from 1 July 2004, the Government amended the negative taxation and cash flow consequences for individuals transferring their retirement savings to Australian funds. IFSA would not like to see these individuals disadvantaged because of the imposition of the new contribution limits.

IFSA proposes that an exemption from both the UDC and CDC cap be provided for overseas transfers into Australian superannuation funds. Given past behaviours utilising overseas arrangements to avoid Australian taxes, IFSA recognises that rules will need to be developed to prevent such manipulation, particularly circumvention of the contribution caps. It may be possible to obtain certification from the relevant local authority where the arrangements need to be registered. This would tend to mitigate against unregulated schemes which could be used to deliberately flout overseas and Australian law. The ATO could, for example, establish a list of recognised funds or jurisdictions.

In addition, the Government could require that the member must have been a non-resident for a continuous period of at least 12 months before being entitled to transfer superannuation entitlements from the overseas jurisdiction which will not be counted toward the caps.

3. Proceeds from the sale of a small business

IFSA is concerned to ensure that small business owners who do not generate significant capital gains from the sale of a small business are still able to contribute a reasonable lump sum into superannuation for their retirement. Situations where we consider exemptions, or higher limits should apply include:

- the proceeds of the sale do not consist of a capital gain (or may consist of a very small capital gain);
- the business is eligible for the 15 year CGT exemption; and
- the business is a pre-CGT asset.

Currently, under the proposed rules, the proceeds of the sale would need to be contributed as an undeducted contribution and would be subject to the $150,000 annual or $450,000 3-year cap.

IFSA does not consider that these limits are adequate for many small business owners, many of whom save through their businesses for retirement and therefore have very little in superannuation compared to employees who benefit from the superannuation guarantee. They may be unable to use the $450K ‘bring forward’ provisions because they may be close to or over 65 and, once their business is sold, they will no longer be working.

In order to cater for the situations outlined above, we propose that on a sale of any small business, the owners are entitled to contribute up to $500,000 (consisting of CGT exempt plus UDC or all UDC) which would be equivalent to the CGT exempt component concession currently available. In this way there is no difference in treatment depending on the level of the gain and the date the business was commenced. The eligibility rules currently applying to the small business CGT concessions would need to be met. This would be a one-off exemption per qualifying individual.

Indexation of the contribution limits

IFSA considers that the contribution limits should be adjusted on a regular basis to keep pace with increases in average wages. However, we recognise the simplicity advantages of ensuring the caps are kept at rounded levels. Rather than requiring ongoing, yearly indexing, IFSA proposes that the Government commit to making 5-yearly adjustments, in line with AWOTE and rounded up to the nearest $1,000.

Breaches of the contribution caps and death

Under the new arrangements it is possible that a member could breach either the undeducted contribution limit or deductible contribution limit and die before any action to enforce the caps is undertaken. It is suggested that in these circumstances the excess be ignored as applied under the surcharge regime.

4 CONTRIBUTION INCENTIVES FOR THE SELF EMPLOYED

IFSA is very supportive of allowing the self-employed to claim a full deduction in respect of their superannuation contributions as proposed in Chapter 5 of the Plan. IFSA also strongly supports the Government’s Plan to extend co-contributions to the self-employed.

5 AGE PENSION ARRANGEMENTS

IFSA supports the reduced taper rate applying under the age pension assets test as proposed in Chapter 6 of the Plan. This initiative will greatly improve incentives for individuals to accumulate savings for retirement. The removal of the 50% assets test exemption for income streams purchased after 20 September 2006 will also simplify the retirement income system and in conjunction with the new minimum payment rules allow product providers to develop products that better meet the needs of individual retirees. We strongly support the Government's plan to grandfather the 50%/100% assets test exemption for complying income streams purchased prior to 20 September 2007.

IFSA's suggestions regarding the income test treatment of pensions are outlined under *"Payment rules simplified"*.

6 OTHER MEASURES

Non-quoting of tax file numbers (TFNs)

IFSA supports the Government's plan to ensure superannuation funds hold the tax file numbers of their members as a key mechanism for managing identification requirements necessary under the contribution cap regime. We are keen to work with the Government to ensure the strategies for TFN collection are as effective and efficient as possible.

However, IFSA has identified a number of difficulties with the ability of funds to populate TFNs for every member. We understand that TFNs are not compulsory even as part of the income tax return processes. Bearing this in mind, IFSA's recommendations below are aimed at a significant level of compliance and risk minimisation.

Difficulties with proposals in the Plan

IFSA has concerns about the implementation of the TFN proposals set out in the Plan given the significant systems changes and client communications that would be required. This is of particular concern in the context of the large scale systems changes required for other core aspects of the Plan as well as the impending anti-money laundering reforms, which will establish requirements relating to identification of clients/customers.

1. Member Apathy
The Plan proposes to invoke penalties where TFNs are not provided to the funds by members. IFSA's first concern with this approach is that the penalties may not change the behaviour, ie., the objective of providing the ATO with TFNs for all members will not be met. Anecdotal evidence suggests that employer funds typically hold a very low percentage of member TFNs, and that these same members do not read their annual statements and will therefore be unaware of the tax penalties which have been imposed on their superannuation account.

2. Rejecting Contributions
We note that funds will face difficulties in rejecting contributions that are not paid directly by the member in certain circumstances including:

- contributions paid via BPay;
- contributions paid via clearing houses; and
- contributions paid to the fund on behalf of the member by the employer.

In these circumstances, it will be difficult for funds to ensure that the contributions are returned to the member. There are other consequences of rejecting contributions which need to be considered, for example, non payment of insurance premiums and resulting cancellations of policies and non-eligibility for co-contributions.

3. Deductible contribution threshold
IFSA is concerned that the $1,000 threshold will penalise a significant number of lower income earners. It should be noted that those who have deductible contributions made on their behalf at this level or below are quite unlikely to be in breach of the deductible contributions cap of $50,000 per year, even with multiple employers.

4. System and administration functionality
The proposal would require funds to develop and implement new systems and processes to apply tax at the top marginal rate. In addition, where a TFN was supplied at a later date, additional

functionality would presumably need to be built to provide refunds of this tax to the member account. Depending upon the mechanisms, we could be facing another complicated and costly surcharge-like regime, which should be avoided for all parties concerned.

5. TFN exemptions
Certain persons are currently exempt from providing a TFN. In these cases, codes are used in place of the TFN when reports are sent to the ATO. How does the Government propose to deal with this situation?

Possible solutions

The following options are intended to achieve the objective of collecting TFNs for a large majority of the superannuation population. A combination of these suggestions could be implemented for maximum effectiveness.

1. Employer provision of TFNs
The greatest area of non-provision of TFNs is employees in employer funds. We propose that the Government legislate to require employers and superannuation contributions clearing houses to provide employees' TFNs to the superannuation fund that accepts contributions on behalf of members.

Employers are already required to pass TFNs to funds if those TFNs have been quoted for a superannuation purpose. If employees have quoted TFNs for another purpose (eg. PAYG) then the employer is not currently authorised or compelled to pass them on. So there are two options:

- Amend the relevant law so that if a TFN is quoted for other purposes, the employer is authorised to pass it on to funds.
- Amend the law compel employers to request and pass on employee TFNs for superannuation purposes.

Requiring employers to provide TFNs to funds would mitigate problems associated with member apathy in relation to fund communications.

2. Increase the threshold for deductible contributions
IFSA considers that the proposed $1,000 threshold should be raised to $5,000. This will mitigate problems outline at *"3. Deductible contribution threshold"* above.

3. Refundable penalty tax – claim back via ATO
IFSA suggests that members should have until 30 September in the financial year following that in which the contribution is made to provide their TFN to the fund. This would ensure funds (and the ATO) have enough time to properly communicate the new requirements to members. If, by the required date, the member had not supplied their TFN, the fund would deduct tax on the original contribution (both deductible and undeducted) at a withholding rate of 31.5%, effectively the highest marginal rate given the application of contributions tax.

Treating deductible and undeducted contributions on a consistent basis allows for simplicity and avoids issues with rejecting contributions outlined above under "*2. Rejecting Contributions".*

If a policy of imposing tax at the highest marginal tax rate where no TFN has been quoted is to be enforced on the basis that a refund of tax will be available upon quotation of a TFN, IFSA strongly recommends that the member 'claims' back the penalty tax via their tax return. This approach would require funds to treat this as a member withholding tax, not as a fund tax liability, so that the ATO can match the tax with the member. The reclaimed tax penalty could be directed to a fund of the member's choice.

We suggest that if the ATO is able to match the member to a TFN under this process, the ATO should be required to pass the TFN onto the fund.

We note that an approach such as this would require significant additional systems and administrative functionality, including a requirement to provide contribution information in rollover statements to cater for situations where a rollover is processed prior to tax being withheld on the contributions.

<u>4. TFN exemptions</u>
Confirmation is required that the exemptions referred to at *"5. TFN exemptions"* above will continue, and where a member quotes an exemption, the proposed new rules will not apply.

Delayed commencement

Critically, given the difficulties and the varying degrees of complexity associated with the possible solutions outlined above, IFSA believes that there is insufficient time for the Government and industry to establish a reasonably robust solution by the proposed commencement date of 1 July 2007. We believe that a delay of at least one year is necessary in order to:

- Plan and run effective awareness campaigns at Government and fund level targeted at both members and employers;
- Build fund systems and administration functionality;
- Allow for further consultation between the Government and the industry on strategies for collecting TFNs with a view to ensuring the workability and effectiveness of the arrangements;
- Give employers sufficient time to understand their obligations to collect and pass on TFNs, as per our proposal outlined above; and
- Deal with existing accounts where no TFN has been quoted.

We don't believe that there is any solution that will ensure 100% compliance with quoting of TFNs. However, we would anticipate that the utilisation of a range of solutions will ensure far greater population of TFNs than is currently the case. Once we have assessed the results of strategies aimed at both members and employers which are designed to populate member records with TFNs, we can revisit options to deal with the situations where TFNs remain outstanding. We are of the view that these options may well be different to those proposed under the Plan and could be complemented by or substituted with identification processes associated with anti-money laundering requirements.

7 UNTAXED SCHEMES

Rollovers from untaxed schemes to taxed schemes

The Plan proposes that the transferring fund would apply tax at the top marginal rate to amounts in untaxed taxable components in excess of $700,000. Such amounts would be transferred/rolled over as exempt components. It is assumed that amounts below $700,000 would be transferred/rolled over as untaxed taxable components.

Amounts transferred from untaxed funds to taxed funds will only consist of two components: exempt and taxable. However, the taxable component may consist of 'untaxed' and 'taxed' elements where the fund is partly funded or contains funded elements. IFSA requests confirmation that this is the case, and that the receiving fund can rely on the components reported in the transfer/rollover documentation to record the components in its own computer system ie. if the taxable component consists of 'untaxed' and 'taxed' elements, these will be reported by the transferring fund. The receiving fund will then apply 15% tax to the untaxed element of the taxable component, thus converting the untaxed element to a taxed element, so that the receiving fund's computer system then only holds two components: taxable (with no split between untaxed and taxed elements) and exempt.

IFSA suggests that an alternative approach which could be considered is to have the transferring fund deduct the 15% tax on the taxable component at the same time as it is applying tax at the top marginal rate to amounts above $700,000. The rollover documentation would thus be simpler – requiring only the two new components to be reported, with no split between taxed and untaxed elements for the taxable component.

8 MAKING IT EASIER TO FIND AND TRANSFER SUPERANNUATION

The following suggestions relate to Chapter 9 of the Plan, regarding the Government's proposals to make it easier to find and transfer superannuation.

IFSA welcomes the proposals as a step towards enhancing the ability of fund members to exercise choice of superannuation funds. We support the Government's intention to simplify the rollover process for all members, not just those with lost accounts. The following IFSA proposals are designed to address some of the barriers, real or perceived, that are preventing effective transfers and rollovers.

Reduction of time limit from 90 to 30 days to complete transfer requests

IFSA supports the introduction of a maximum 30 day limit under which super funds must complete a transfer request. However, as outlined in our suggestions below, we believe that the current law will need to be amended to give proper effect to the implementation of this proposal.

Missing or inadequate records at the "from" fund

We are concerned to ensure that the 30 day time limit would not commence until valid request is received by the trustee of the "from" fund. A valid request would include a completed standard portability form and any records required to correctly identify the member.

We consider that fund members should be able to submit a transfer request form to either the "from" fund or the "to" fund. Ultimately, it will be the responsibility of the trustee of the "from" fund to ensure the member's benefits are paid to the "to" fund within 30 days of either fund receiving a valid transfer request.

Some funds, particularly employer/corporate funds, hold inadequate details about a member, mainly relating to the lack of signatures, and out of date records or identifiers.

At a minimum, we suggest that members should provide a signature and one form of certified identification eg. passport or driver's licence. We note however, that difficulties can arise due to the different certification requirements between states, potentially causing delays in processing transfer requests.

These difficulties may be resolved if SIS law can prescribe one certification rule that can satisfy all rollover and transfer requests. We believe that a signature from a JP or a solicitor stating that the copy attached to the form is a true copy of the original should suffice in most cases. We are happy to further consult on appropriate certification rules if needed.

Illiquid Investments

IFSA considers that an extension beyond the 30 day time limit should be granted where the member has elected to invest in a portfolio that is infrequently priced due to the nature of the underlying investments. This extension would apply in situations where a member had knowingly elected to invest in a portfolio where the underlying investment is illiquid. In these circumstances, the timeframe required to liquidate such investments is dependent on underlying fund manager requirements which would be disclosed to the member prior to entering into the investment.

Employer's time limit obligations under super choice

Currently, an employer has an obligation to pay any superannuation guarantee contributions which fall due 2 months after an employee choice form is received.

In the event that a transfer is processed prior to an employer giving effect to an employee's choice of fund, the fund receiving employer contributions may be required to return them if the employee is no longer a member of the fund. This could have implications for employers under their SG obligations.

To mitigate these difficulties, IFSA suggests that the 30 day time limit for transfers should be consistent with an employer's obligations under super choice. Accordingly, we suggest that the time limit required for employers to give effect to an employee's choice of fund should be reduced from 2 months to 30 days.

Standardised portability forms

Different identity checking processes of different funds can cause delays to transfers and rollovers. For example:

- identification information to complete transfers can be different for different funds; and
- transfer documentations used by some funds may not be considered acceptable by other funds.

These differences can be disconcerting and confusing to members, and can undermine member choice. Trustees of funds may also feel they have different obligations in order to satisfy themselves that a request is valid.

The introduction of standard requirements would minimise the delays caused by the different requirements between funds. Our comments on the Standardised portability form are below.

Content of the standard portability form

We are supportive of the work undertaken by ASFA in establishing a draft standard portability form. The following IFSA suggestions represent refinements to ASFA's proposed form.

- We suggest that a standard portability form should be given the flexibility to be brand specific to a fund.

- The form should also have some sort of identifier that recognises it as being the industry accepted format.

- With reference to the declaration in section 4 of ASFA's proposed form, we recommend that the member also be required to declare that they are *"aware of the insurance implications of the transfer, and the possibility that insurance cover, if applicable, may be lost."*

- In order to ensure members are aware of the requirements to provide a fund with sufficient proof of their identity, IFSA proposes that the following statement be included in the standard portability form, preferably on the first page.

  "The trustees of your old fund and of [this fund] both have an obligation to ensure that your transfer request is processed and that the funds are transferred to [this fund] within 30 days from the date of receipt of this form unless your old fund does not have complete and up to date records of your identity, such as a current signature, date of birth and current home address.

  "The trustee of your old fund will inform you of the missing records as soon as is practicable, and your transfer request will only be processed within 30 days starting from the day the missing record is made available to your old fund."

Process to facilitate transfer should not be restricted

While IFSA supports making transfers mandatory when a fund receives a completed paper based form, we believe that the receipt of a manually completed paper based standardised portability form must not be the sole means by which transfer requests can be accepted and actioned. In the interests of efficiency and simplicity, there should be no restrictions imposed on processing phone, fax or electronic transfer requests.

We believe that a great disservice will be done to members if a paper-based standardised portability regime undermines other, potentially more efficient ways, of communicating transfer instructions.

For example, funds without exit fees or insurance, who can clearly identify a member should retain the ability to accept simple instructions from the member via a phone call in order to process a transfer. Transfer requests via electronic forms will also be able to satisfy trustee requirements in a significant number of cases.

Trustee obligations

SIS Regulation 6.34(2) imposes an obligation on a trustee to be satisfied that the fund member is aware that he or she has a right to seek certain information from the trustee before a roll over can occur. The regulation does not prescribe the length to which a trustee must go toward satisfying this obligation, allowing different practices and leading to some transfers being slower than others.

IFSA considers that this Regulation should be amended to make it clear that a trustee has met its obligations when accepting a request to rollover following receipt of a standardised portability form. In this regard, we believe that the declarations signed off by the member in the form should suffice to confirm that the trustee has met its obligations.

Limitations of the Government proposals to find and transfer superannuation

We have identified the following barriers to the Government proposals on superannuation rollovers that should be resolved.

Partial rollovers

We believe that the Government proposals on super rollover should only apply to full rollovers. Partial rollovers are both infrequent and more complicated. The proposed ASFA standard portability form will not be able to properly address requests for partial rollovers.

IFSA therefore considers that there is a need for further consultation to standardise the process for partial rollovers.

Lack of member awareness

The engagement of super fund members is important to ensuring smooth transfer process. IFSA members are keen to work with Government to increase member awareness of the process for rollover and transfer. We believe, for example, that standard portability forms should be easily accessible over all relevant public and private websites.

IFSA recommends that the introduction of the Government’s proposals should be accompanied by a public awareness campaign run by the ATO and supported by industry. We believe that it will be important to educate members about the implications of transfers and rollovers particularly the need to provide funds with valid and complete information and proper identity matching procedures.

Implications of anti-money laundering (AML) reforms

We believe the passage of the anti money laundering legislation and its impact on identity checking requirements for superannuation fund trustees could undermine these proposals.

IFSA considers that the identity matching requirements set out in this submission should be more than adequate for AML purposes. We appreciate, however, that a separate consultation process is in progress for AML. To the extent the outcome of AML may be incompatible with the Government rollover simplification proposals, we would be keen to ensure minimal duplication in respect of various identity checking requirements and would be happy to consult with Treasury on these issues further.

ATO's lost members register

Some of the comments raised above will also apply to rollovers facilitated by the ATO. We caution, however, that while making transfers easier by removing member involvement may assist in reducing the number of lost accounts, it may not be achievable in some instances. Member involvement cannot be avoided in cases where incomplete or out of date identity records are kept by the super fund.

9 OTHER ISSUES

CGT Rollover Relief

The proposed changes will require superannuation providers to amend their systems in order to reflect the new regime. Many providers have legacy systems reflecting corporate mergers and previous taxation and social security regimes. Such providers will be reluctant to incur costs in amending such systems. Ideally they would like members to move to new superannuation products on current systems. One of the key constraints preventing this happening is that in moving members and assets from a legacy product a liability to tax on capital gains will be incurred.

It is suggested that some form of CGT rollover relief should be implemented with these changes. Such relief would allow members' assets to be transferred from a legacy fund to a successor fund whose supporting systems complied with the new regime. Such relief has been made available in the past most recently in the context of the new superannuation safety rules that required providers to be licensed. The relief in this instance was contained in subdivision 126F of the *Income Tax Assessment Act 1997*.

Specifically similar CGT relief should be made available where members and assets are transferred to a successor fund by reason that the successor fund is able to comply with the new regime. Such relief should continue for at least 2 years after 1 July 2007.

To not provide such relief risks the creation of a whole new group of legacy products, this will only further confuse the general public in its understanding of superannuation and pensions.

Additionally some providers of superannuation products have adopted structures whereby the superannuation funds are investing through a life insurance company. That is the structure is:

Member
I
Superannuation Fund
I
Life Insurance Company
I
Assets

Rollover relief needs to also be provided so that assets can be transferred without a tax cost directly to the superannuation fund or indeed another successor superannuation fund. Such relief needs to be two fold. Firstly, CGT relief is required so that the life insurance company transferring the assets does not realise a capital gain. Secondly, so that the superannuation fund taking over responsibility for the member is deemed to have acquired the assets with the same cost base as the life insurance company and at the time the life insurance company acquired the assets.

Systems issues

Superannuation funds will need sufficient time to align their computer systems, processes and documentation with the new requirements. Without this, there is a risk that funds and regulatory bodies (such as the ATO) may be unable to deliver the changes by 1 July 2007.

The final legislation/regulations are not expected until March 2007. Funds and regulatory bodies cannot wait until March to start specifying systems and procedural changes. Yet they cannot deliver these specifications without the full detail of the measures.

Given the size and scope of the proposed changes and the tight time frame, we would like to explore whether the Government is able to give an undertaking to provide sequential tranches of legislation as well as updates on a regular basis following the end of the consultation period up until the final Bill(s) are introduced into the Parliament and final Regulations are made.

IFSA notes that many of the systems changes required will have a build time of more than 6 months (and in some cases more than 12 months depending on the final rules) and some cannot be made simultaneously. To facilitate staggered release of critical legislation, IFSA would be happy to provide further detail on key aspects requiring longer systems lead times.

Application of Medicare levy to tax rates

Under the proposed regime various tax rates are proposed for various types of payment and circumstances. The Government needs to clarify whether the Medicare levy does or does not apply to each type of payment. In particular it is suggested that death benefit payments to non-dependants should not be subject to the Medicare levy in much the same way as the estate is exempt from the Medicare levy.