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A Plan to Simplify and Streamline Super ("Simpler Super")

SMSF Strategies seeks to make a submission in relation to the proposed Simpler Super reforms and in particular their impact on the self managed superannuation fund ("SMSF") sector.

By way of background SMSF Strategies is an independent company that provides SMSF advice, business and compliance tools to accountants, financial planners and trustees of SMSFs. The two principals of the company, Grant Abbott and Amreeta Hughes have trained or advised on SMSF issues to more than 20,000 accountants, financial planners and trustees. In addition Grant Abbott has authored the "Guide to SMSFs" published by CCH (in its third edition); a SMSF text book extensively used by accountants, financial planners, specialist SMSF advisers and trustees.

For more on SMSF Strategies, the SMSF industry and the Simpler Super Reforms please review our specialist SMSF websites: www.smsfstrategies.com and www.smsf.tv. Our contact details are smsfstrategies@yahoo.com

Importantly SMSF Strategies commends Treasury and the Government for releasing the Simpler Super reforms for public comment to enable thoughtful consideration to be given to the mechanics and practical implications of the reforms before implementation.

1. Government Retirement Incomes Policy

The purpose of the government's retirement incomes policy as stated in the Treasury Intergenerational Report published in 2004 is as follows:

> "The Government is committed to a retirement income policy that provides encouragement for individuals to provide a higher standard of living than would be possible from the Age Pension alone, but also ensures all Australians have security and dignity in retirement. This will be achieved by:
>
> encouraging people who are able to save for their retirement to do so, particularly through superannuation;

ensuring the provision of an adequate public safety net in the form of an Age Pension for Australians who are unable to support themselves in their retirement years;

ensuring the system is predictable, but facilitates choice and is equitable; and

ensuring the system is fiscally sustainable and delivers an increase in national saving.

The Government believes these objectives can be met by the current three pillared retirement income system comprising:

voluntary superannuation and other private savings;

compulsory superannuation savings through the Superannuation Guarantee contributions; and

a means tested Age Pension and associated social security arrangements."

It is recognised that in making any submission on the Simpler Super Reforms the retirement income principles considered above should be taken into account.

2. The Simpler Super reforms

In proposing the Simpler Super reforms, Treasury stated "that the Government's proposed plan would

- simplify superannuation arrangements for retirees, making it easier to understand;
- improve incentives to work and save; and
- introduce greater flexibility in how superannuation savings can be drawn down in retirement.

If the proposed changes are implemented, the adequacy of retirement incomes would be improved, and over 10 million Australians with superannuation accounts, plus future account holders and their families, would benefit through greater simplicity."

In making a submission, SMSF Strategies commends the Government on its' proposed Simpler Super reforms. In SMSF Strategies opinion the overall reforms are positive for the SMSF industry and will see continuing, if not accelerated growth in SMSFs.

3. Background on SMSFs

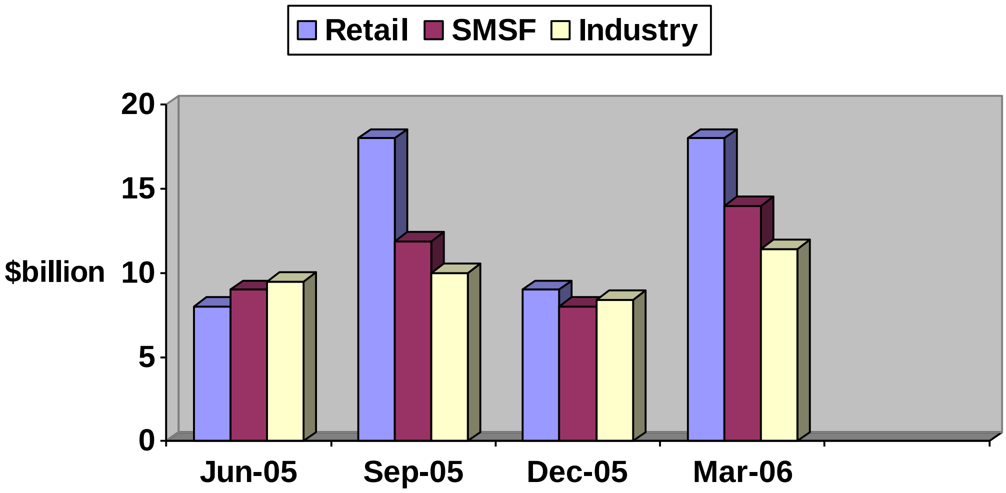
Prior to making a submission on the Simpler Super Reforms, SMSF Strategies provides a brief background on the SMSF industry in the context of the proposed reforms.

3.1 SMSF Statistics

According to APRA, at 31 March 2006, the Australian superannuation industry had 900 retail, employer and industry based funds with $648B. In contrast there were 317,000 SMSF funds with $208B in assets. On current growth patterns by the time that the Simpler Super Reforms are in force – 1 July 2006, there will be in excess of $270B in these small family funds.

In terms of quarterly growth in assets under management, the last published figures for the superannuation industry by APRA reveal the following:

<u>Diagram one – Growth in Superannuation Assets – March 2006</u>



As can be seen from Diagram one the growth in SMSFs on a dollar for dollar basis is on par with the retail and industry based superannuation funds. This is the case even though both of those sectors have multi-million advertising and marketing budgets. Employee choice, pre-retirement pensions, super splitting and now the Simpler Super Reforms will continue to see SMSFs hold their own and cement their place as the second force behind retail superannuation funds.

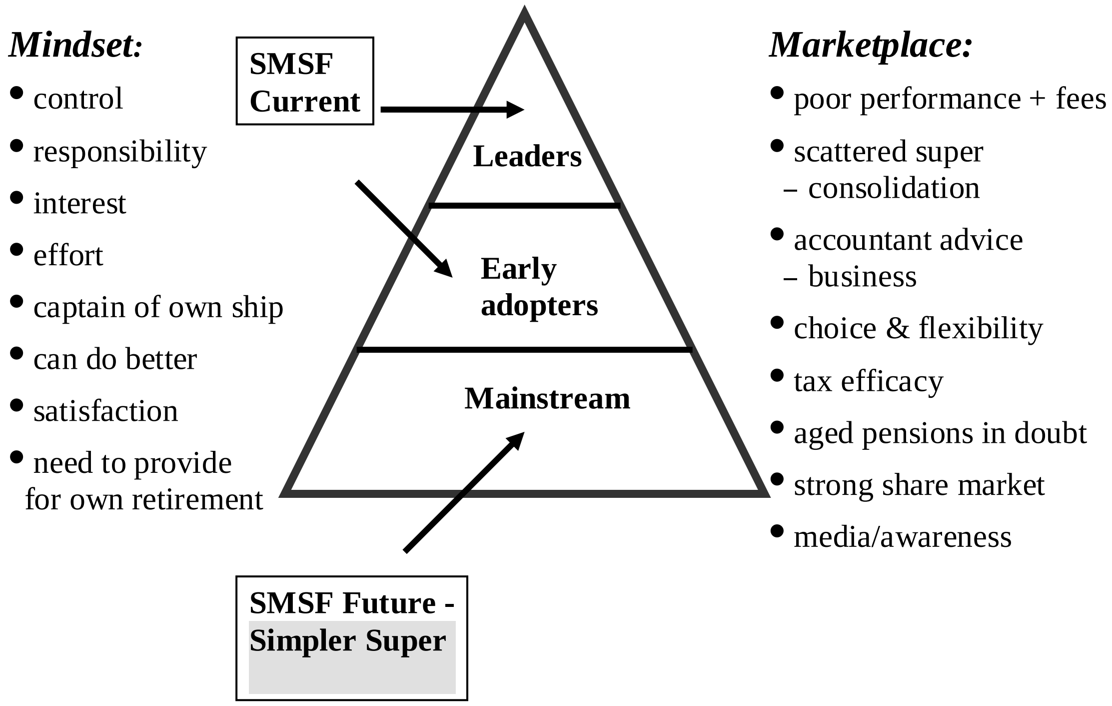
Inflows in terms of contributions into these funds are above average in dollar terms courtesy of the average member balance for a SMSF being greater than $240,000. This may be compared to the retail superannuation funds where the average member balance is only $13,000. As such any changes to the deductible and undeducted contributions rules will have a significant impact on this sector of the superannuation industry.

As an aside APRA produces regular quarterly statistics in terms of the various sectors of the superannuation industry excluding SMSFs which are regulated by the ATO. SMSF Strategies submits that the provision of statistics by the ATO on a quarterly or at worst case annual basis on the state of play of the SMSF sector would provide qualitative information for trustees, regulators, Government and other stake holders enabling them to adequately manage, administer, plan for and provide for this important sector.

3.2 Reasons for SMSF growth

There are many reasons for the growth in SMSFs. Diagram two below, taken from a market research study undertaken by the ASX in 2003, shows why SMSF trustees chose a SMSF over other superannuation funds.

Diagram two – SMSF choice characteristics



★The spread of SMSFs into the mainstream working population is expected to continue once the Simpler Super Reforms commence on 1 July 2007.

3.3 SMSF administration is not sophisticated

Most SMSF administration in Australia is managed by thousands of accountants. According to an ATO research paper published in 2002 there are more than 9,000 accountants looking after SMSFs with 90% of the accountants administering ten funds or less. For the majority of accountants running SMSF administration, administration is generally a year end - shoe box style of approach.

By its very nature shoe box style administrators require the client to do a lot of the work. This reduces the cost to the client. The process of shoe box style administration is as follows:

> at some stage in August through to February following the end of the relevant income year, the client provides the accountant with a list of information including realised gains and losses; cash account statements, income flows, pensions and lump sums paid and so on for the fund from the prior income year.

- the material is prepared into a set of accounts for audit purposes.
- an audit file is prepared and then sent to the auditor who will conduct the audit from the work papers prepared by the accountant.
- upon sign off the next step is to prepare member statements, lodge income tax returns, GST returns and prepare minutes plus the fund's investment strategy.

The cost of the preparation of accounts, audit, tax returns and the like is between $750 and $2,000 depending upon the size of the fund and the number of transactions undertaken.

3.4 SMSF issues to be taken into consideration with the Simpler Super Reforms

The Simpler Super Reforms are wide ranging. The most telling feature is the flexibility of a member of a superannuation fund being able to choose a pension, a lump sum or both once they retire. In practice some members may choose to run only a lump sum or a pension account in retirement. However over time, SMSF Strategies is of the view that a large number of SMSF members will end up holding two superannuation accounts – a pension account and a lump sum account. Moreover holdings between the two accounts will be switched regularly as more astute members use their pension account for lifestyle income and their lump sum account for estate planning purposes.

In a retail, employer or industry based superannuation fund this switching means higher fees, higher taxes and less flexibility. Members of a master fund superannuation account or superannuation wrap account that have chosen a specific investment portfolio will not be able to switch investments from one account to another. In comparison the trustee of a SMSF will not incur any extra costs where members run separate lump sum and pension accounts. Nor will there be any barriers to switching specific assets between accounts where the trustee runs separate investment strategies.

Submission 1: Simpler Super Reforms to grow number of SMSFs

SMSF Strategies submits that the Simpler Super Reforms will seen an increase in the number of SMSFs over time particularly with members of a fund that have benefits in excess of their lifestyle income needs that are sought to be passed onto the next generation by way of the lump sum account.

Submission 2: Contribution rules to limit growth in assets in SMSFs

SMSF Strategies submits that the proposed contribution limits in the Simpler Super Reforms will have a significant impact on the SMSF sector. This will see a decrease in the amount of contributions being made into SMSF but with an increase in the number of funds as a result of the Simpler Super Reforms, a decrease in the average size of SMSFs.

Submission 3: The Simpler Super Reforms to increase complexity and costs for SMSFs

SMSF Strategies submits that the breadth of the Simpler Super Reforms will increase the complexity of SMSFs and the cost of preparing accounts and audit. The proposed contribution administration systems will create problems for accountants and trustees of SMSFs. Possible changes to the system that would suit SMSFs yet achieve the government's aims are considered in detail below in the contributions section of this submission.

Submission 4: All SMSF trust deeds will need to be upgraded

Section 55(1) of the Superannuation Industry Supervision Act 1993 ("SIS Act 1993") requires the trustee of the fund to abide by the governing rules. Failure to do so, in terms of a SMSF may render the fund a non-complying SMSF, the fund subject to significant tax penalties and the trustees of the fund penalised monetarily.

The Simpler Super Reforms are not included in any current SMSF trust deed rules and will require current SMSF trustees to upgrade their trust deeds to cater for pension, death benefit, contribution and the abolition of compulsory cashing reforms.

SMSF Strategies submits that the Government run an education campaign targeted at trustees of SMSFs and their advisers to educate them on the need to upgrade their current SMSF trust deeds should they wish to take advantage of the Simpler Super Reforms.

4. Undeducted contribution ("UDC") limits

4.1 Introduction

One of the planks of the government's retirement incomes policy is to encourage people to save for their retirement. Over the last three years more than $18 billion of undeducted contributions have been made by members of a SMSF – showing that the current system of encouraging self funding retirees is working. The Government has in the past nominated the growth in undeducted contribution figures as a measure of the success of its retirement incomes policy.

4.2 The Laws

In terms of limiting contributions into a SMSF or any superannuation fund for that matter, Section 32(2) of the Superannuation Industry Supervision Act 1993 ("the SIS Act") provides that regulations may be introduced to set standards as follows:

> (2) The standards that may be prescribed include, but are not limited to, standards relating to the following matters:
>
> (c) the amount of contributions that a fund may accept.

To date there has been no limitation placed on the amount of contributions that may be made under the SIS Act 1993 - although there are limits in terms of tax deductible contributions under the Income Tax Assessment Act 1936.

4.3 Simple Super Reforms

The Simple Super Reform proposals state the following in terms of limiting UDCs:

> **Member contributions (paid from after tax income) – p19**
>
> These are contributions made from income after the individual has already paid tax on that income. Member contributions would be subject to the following taxation treatment.
>
>> No tax would be payable when the contributions are made (given income tax would have already been paid on the income). *These contributions would be limited to $150,000 in an income year* (three times the limit on concessionally taxed deductible contributions).
>>
>> Earnings on these contributions would continue to be taxed at a concessional rate of a maximum of 15 per cent (10 per cent on capital gains where the asset is held for 12 months). Tax payable on earnings would still be able to be reduced through the application of imputation and other credits.
>>
>> No tax would be paid on these contributions when they are paid to the individual as superannuation benefits (irrespective of whether the benefit is taken as a lump sum or pension).
>>
>> A Government co-contribution will continue to be paid for eligible persons (now including the eligible self-employed) on incomes up to the co-contribution upper threshold, and no tax is payable on the co-contribution.
>>
>> Contributions in excess of the cap would be returned to the individual. Any earnings on the excess would be effectively taxed at the top marginal tax rate of 45%.
>>
>> The ATO would collect the necessary information on contributions in order to determine when a person has exceeded the annual cap. This would trigger a return of the excessive contributions and earnings. Rules would be developed to determine which contributions are refunded in the case of multiple contributions and funds.
>>
>> The CGT exempt component from the sale of a small business (Subdivision 152-D of the Income Tax Assessment Act 1997) will not be included in the cap.

4.4 Case study highlighting contributions cap complexity

SMSF Strategies submits that the proposed UDC cap measures introduce unnecessary complexity to the administration system. The following simple sale of a business case study reveals this complexity.

- **Sale of a Business Case Study**

John Smith - aged 59 and his wife Jean – aged 52 sold the business they ran in partnership for $1.6M on 1 June 2006. The business was set up from scratch in 1996 and the sale price consisted of goodwill only. As such they each have $800,000 of capital gains. At this stage John has $200,000 in benefits in a retail super fund with Jean only $100,000.

Tax wise they are able to use the ordinary and small business CGT concessions to reduce their tax on the sale of the business to nil. In short this means that under the ordinary CGT rules there is a 50% discount which will reduce their capital gains to $400,000 each. Under section 152-C of the Income Tax Assessment Act 1997 a further 50% exemption applies leaving each of them with $200,000 of capital gains. Both of them intend on claiming the CGT retirement exemption under section 152-D for the remaining $200,000.

Let's consider what may happen with the $1.6M proceeds on the sale of the business - $800,000 for John and Jean and how each transaction impacted by the proposed Simple Super Reform limit on undeducted contributions:

Transaction	Date	Amount	John's Super Account	John's Pension Account	Jean's Super Account
John rollovers CGT exempt component to retail super	1/6/2006	$200,000	$400,000	$0	$200,000
John contributes $300,000 as spouse contribution to Jean	2/6/2006	$300,000	$400,000	$0	$500,000
John contributes $300,000 UDC into retail super under three year rule	2/6/2006	$300,000	$700,000	$0	$500,000
Jean rollovers CGT exempt component	2/6/2006	$200,000	$700,000	$0	$700,000
Jean contributes $300,000 as spouse contribution to John	3/6/2006	$300,000	$1M	$0	$700,000
Jean contributes $300,000 UDC	3/6/2006	$300,000	$1M	$0	$1M

into retail super under the three year rule					
Jean splits 100% 2006 spouse and UDCs to John	4/7/2006	$600,000	$1.6M	$0	$400,000
John commences a transition to retirement pension with $800,000	3/8/2007		$800,000	$800,000	$400,000
Jean and John rollover their benefits to SMSF	1/9/2007		$800,000	$800,000	$400,000
ATO determines possible breaches of the cap	1/4/2009		$1.1M	$700,000	$550,000

4.5 Case Study Issues

SMSF Strategies submits that there are a number of important questions raised by the case study and currently not considered in the detailed Simpler Super Reform paper:

i) *Spouse and other non-employer contributions*

The Simpler Super Reforms and the Contribution fact sheet on the Treasury web site indicate that the proposed cap applies only to member undeducted contributions. Therefore the following questions must be asked:

Are spouse contributions to be included as part of the cap?

Where a person other than a member makes a contribution on the member's behalf (not an employer contribution) will this be included under the UDC cap?

ii) *Spouse splitting*

The spouse splitting rules allow a member of a fund such as Jean to split 100% of her undeducted and spouse contributions to John. However if she splits and the ATO later deem that some of the splitting contributions were in excess of her cap:

Will they be taken from John's account?

If they are taken from John's account which account is it to be taken from - the pension or the lump sum account?

Are they to be taken from Jean's account?

What happens if at the time of the ATO making the assessment that the member's superannuation balance is less than the ATO assessment or nil?

iii) Change in fund consequences

Where a member of a fund such as John or Jean is deemed to be subject to excess UDC requirements then rolls over their benefit to a SMSF how will the ATO implement the return of the excess and penalty tax on income? Many SMSF practitioners experienced the problems with the ATO administering the superannuation surcharge where assessments were sometimes five years late. What would the Commissioner of Taxation do in the above case study if it takes five years to make an excess UDC assessment?

iv) Assessment problems

It is proposed that the ATO determine a member's UDC and then provide the trustee of a fund with directions in terms of returning any excess. This will be a task in a SMSF primarily for the fund's adviser. As such:

> What happens if by the time the assessment is made there are no benefits in the member's funds having been withdrawn from super as a lump sum or pension?
>
> Who will pay the 45% tax on excess UDC income if the member has exited superannuation?
>
> Can any refund of UDC be contributed back into the SMSF even if the member no longer meets the work test but did at the time of making the original contribution?
>
> What happens if the member of the fund has died prior to the assessment?

v) What earnings are to be taxed at 45%?

The Simpler Super Reforms propose to tax any earnings on excessive UDCs at the top marginal tax rate. This raises a number of issues:

> Where the purported excessive amount is mixed with other non-excessive benefits and then invested across a wide range of investment options how will the excessive amount be determined?
>
> What if that portion that is possibly excessive UDC remains un-invested by the trustee of the SMSF?
>
> Where a member is running both a pension and a lump sum account, how will the ATO determine the taxation as the lump sum earnings have already been taxed at 15% whilst pension earnings are generally tax free? Is one to be taxed at 30% - lump sum account and the pension account – 45%?
>
> Should the trustee of a fund invest excess UDCs in investments already subject to a tax rate of 45% under the special income rules?
>
> Are earnings or taxable income the subject of excess UDC taxation? Where it is taxable income then capital gains subject to a discount and other amounts that may be taxed favourably would not be taxed.
>
> How is the trustee of a fund to levy the excess UDC earnings tax if the member is no longer in the superannuation system?

If a non-taxable income base is to be used has consideration been given to the extra compliance costs involved in preparing a separate set of accounts?

vi) What about reserves?

Where an investment reserve is put in place by the trustee of the superannuation fund – as is the case for many industry based superannuation funds, where not all fund income is attributed to a member's account, how will this be treated if the underlying contributions were wholly or partly excessive?

vii) Three year provision

It is proposed to allow a person a three year aggregation of the $150,000 UDC cap such that they can contribute $450,000 in any one year but will then be precluded from making further contributions over the next two income years. Is this a rolling amount? For example can a member of a SMSF make a contribution of $350,000 on 30 June 2006 and then a further $400,000 on 1 July 2008? The $400,000 would incorporate the remaining $100,000 of contributions allowed in the 2008-2009 income year and then $300,000 for the 2010 and 2011 income years.

viii) Sale of business

For many small business owners their business is their superannuation. This was recognised by the government when they introduced the CGT small business concessions. The Simpler Super Reforms propose to exempt from the UDC cap the CGT exempt component rolled over into a superannuation fund. However for small business owners the CGT exempt component may be only 10% or less of the proceeds from the sale of their business – after the cost base is taken into account. In some cases where the 15 year exemption is used, there is no CGT exempt component and thus small business owners will have all of their proceeds subject to the UDC cap. The proposal to only exempt the CGT exempt component works against the desire to get Australians working longer as a small business owner may be better selling their business once the UDC three year threshold is met.

ix) Downsizers

As children move away from home and retirement beckons, a number of couples sell their large family home and move to smaller premises. The surplus cash from the sale of the property is used to invest in superannuation. For many this may be their major source of superannuation. The proposed Simpler Super Reforms may limit their capacity to place these proceeds into superannuation immediately and begin earning income for their retirement.

x) Expatriates returning to Australia

Expatriate employees and business owners do not have the luxury of contributing to an Australian superannuation fund during their working life. They may or may not be in a superannuation fund overseas. The Simpler Super Reforms provide that where amounts have been rolled over from an overseas superannuation fund that any subsequent benefits taken from the fund will be subject to a 15% tax rate.

When an expatriate returns home to live in retirement, they may bring non-super amounts that are sought to be placed in a superannuation fund for retirement purposes. As this represents their entire wealth, they will be limited in their use of superannuation for retirement purposes. This may see an increase in the use of tax havens by expatriate employees returning home to Australia to ensure that their retirement monies remain tax free as is enjoyed by other superannuation fund members.

xi) ATO Resources

It is proposed that the ATO will assess whether a member has exceeded their UDC cap, even where contributions are made across a number of funds. In addition the ATO will have to assess the amount of fund earnings that are to be subject to a 45% tax rate. In effect, the proposals are building a new combined RBL and surcharge system based on the amount of undeducted contributions in a fund with excessive earnings components to be taxed at 45%. The amount of reporting and paperwork that will be required to meet ATO assessment requirements will equal both the superannuation surcharge and the RBL administration systems. This runs against the government's desire to make the superannuation system simpler.

Submission 5: Costs will outweigh tax receipts and not prevent excessive UDCs

The Government submits that the introduction of a UDC cap is warranted because:

> "Once in the fund, the earnings on all contributions are subject to the concessional 15 per cent earnings tax which represents a significant concession designed to encourage and support retirement savings. The removal of benefits tax and RBLs would increase the concessions provided to superannuation.
>
> These proposed changes, in conjunction with the current tax exempt status of superannuation pension assets, would make superannuation an attractive vehicle in which to retain assets to avoid paying tax. There would also be an incentive for high-wealth individuals to transfer large amounts of assets currently held outside superannuation to the concessionally taxed superannuation system."

SMSF Strategies agrees with the government that the superannuation tax system provides an incentive for **all** taxpayers to transfer large amounts of their wealth into superannuation. This is one of the stated goals of the Government's retirement incomes policy – "encouraging people who are able to save for their retirement to do so, particularly through superannuation."

SMSF Strategies submits that the proposed system will not prevent high-wealth individuals making excessive UDCs as they would generally be subject to a 45% tax rate on earnings outside superannuation. Where it will impact is upon the small business owner and others who would not generally be regarded as high net worth taxpayers.

It is further submitted that implementing a UDC cap will increase Government costs through complex upgrades to ATO computer systems, increased ATO manpower to determine and audit UDC excesses as well as make public rulings on the subject. Additionally trustees of a SMSF will face significant administration costs to comply with the proposed administration system. These costs will far outweigh any excess UDC taxes paid.

As such SMSF Strategies submits that there should be no change to the current system. This will ensure simplicity and a testament to the success of the Government's retirement income policy.

Submission 6: Broadening UDC cap exemptions

Notwithstanding our preference for submission 5, SMSF Strategies submits that small business owners should be provided with an exemption from the UDC cap for all capital proceeds received from the sale of a business. In addition, proceeds from the sale of a principal place of residence should likewise be exempt. For expatriates any amounts contributed into a fund should not form part of the UDC cap.

Submission 7: Alternatives

Notwithstanding our preference for submission 5 SMSF Strategies raises the following alternatives to the proposed UDC cap system:

1. **Treat excess UDCs as taxable contributions**

   SMSF Strategies submits that an alternative administration system is to ensure that a member makes an undeducted contribution into one fund only (like employee choice). Then any excess UDC can be included as a taxable contribution to the trustee of the fund and taxed at 15%. This will ensure that fund members with excessive UDCs pay their share of tax up front if they seek to make excessive UDCs. Taxable contributions are well understood by trustees of SMSFs. This system thus achieves the simplicity objective while not requiring extra ATO resources. In setting the UDC thresholds, small business owners, expatriates and other disaffected parties should be provided with a broader range of exemptions.

2. **Retain RBLs**

   It is submitted that an alternative may be to retain the RBL system and include undeducted contributions as part of the RBL amount but have a lifetime amount of benefits that may be taken equal to $2M or more. Again small business owners and expatriates should be provided with increased thresholds.

Submission 8: Contributions at any age

Given,

a) the ability to maintain a lump sum account until death; and

b) the proposed contribution limits,

SMSF Strategies submits that there should be no age or other barriers to making contributions into a complying superannuation fund.

5. Increase in taxable contribution taxes

5.1 Simpler Super Reforms

The Simpler Super Reforms propose the following in terms of deductible contributions being made to a complying superannuation fund.

> "It is proposed to streamline the rules for deductible contributions. This involves removing the age-based limits on deductible contributions. Under the proposed arrangements, a limit on concessional deductible contributions of $50,000 per person per annum would apply. These contributions would be taxed at 15 per cent.
>
> Where the ATO identifies that a person's deductible contributions have exceeded $50,000 in a financial year, the amount in excess of $50,000 would be taxed at the top marginal tax rate.
>
> The new threshold would apply per person, irrespective of the number of employers contributing on behalf of the person. *Given the removal of the RBL and tax on benefits, this limit on deductible contributions would play a key role in the fiscal sustainability of the system.*
>
> Assessments by the ATO would be based on information provided by superannuation funds. The 15 per cent contributions tax is currently collected by treating taxable contributions as income of a superannuation fund. The tax payable can be reduced by superannuation funds through the application of imputation and other credits. These arrangements would remain unchanged.
>
> Any additional liability for tax on contributions over $50,000 per annum would be determined in respect of an individual but levied on superannuation funds. Superannuation fund reporting requirements would provide the ATO with enough information to assess contributions tax liabilities as funds, except those that are untaxed, would report all taxable contributions (including notional taxable contributions) made for the benefit of an individual.
>
> Where taxable contributions (including notional taxable contributions) for an individual exceed $50,000 per annum and are made to more than one superannuation fund, the most practical fund(s) on which to levy the tax would need to be determined.
>
> It is anticipated that there would be few instances where this would be necessary."

5.2 SMSF Strategies comment

SMSF Strategies commends the proposal to allow both employers and self employed persons to make unlimited deductible contributions. This will make the administrative system for claiming superannuation contribution deductions much simpler thereby meeting one of the stated desires for the Simpler Super Reforms.

However transferring the tax liability for excessive deductible contributions to the trustee of the fund and taxing contributions in excess of $50,000 per annum at a 45% tax rate raises two important issues:

i) Introducing a 30% Super Surcharge

The proposed new contributions tax system is simply the superannuation surcharge system born again where the trustee of the fund notes the amount to the ATO and then the Commissioner assesses the amount of surcharge to be paid by the trustee of the fund on behalf of the member. However the surcharge has now been raised from 15% to effectively 30% under the Simpler Super Reforms. The rate is extremely harsh given that the top rate of tax does not apply until a person earns $125,000.

From an administration perspective the surcharge provided all manner of practical difficulties for SMSF trustees, accountants and the ATO. It was not a simple system and *significantly discouraged* superannuation contributions (not undeducted contributions). This runs against the two stated aims of the Simpler Super Reforms to:

- simplify superannuation arrangements for retirees, making it easier to understand; and
- improve incentives to work and save.

ii) Pre-retirees don't save until post age 50

From our experience very few members of a SMSF have much in the way of superannuation benefits pre-age 50, either from employer SGC or by way of salary sacrifice. They are not superannuation savers. The general reasons for this, despite the tax effectiveness of superannuation in the long term are:

- current parents had their children later and have them on hand longer than the previous generation. Baby boomers may find themselves supporting their children financially in terms of living, school and university expenses well into their 50's. This reduces the ability to save for retirement until early to mid 50 years of age, if at all.

- the cost of housing has increased significantly over the past 20 years and mortgages are biting deeper plus taking much longer to pay off than previously. The capacity to save by way of superannuation pre-50 isn't available for many Australian home owners.

- margin lending arrangements, negative gearing for property investments and tax effective agricultural schemes take pride of place as investments of choice for many pre-50 year olds where there is an immediate tax benefit from the investment and access if need be. Superannuation, despite its tax effectiveness post age 60 is not favoured pre-50 year olds because of the lack of access.

- with superannuation the Government changes the rules all the time with the Simpler Super Reforms being yet another change. Trust in superannuation as an investment vehicle is at an all time low. Will future governments leave superannuation benefits tax free post age 60?

Given the lack of desire and capacity to save through superannuation until well after age 60, limiting tax effective contributions to $50,000 per annum provides little incentive to work and save. Moreover many will fall well short of their desired lifestyle income if forced to save outside of superannuation. This will place pressure on the Government in terms of aged pension funding. The current limited transitional provisions provide short term relief to the funding problem only.

5.3 SMSF Strategies submissions

Submission 9: Continue with streamlined age based limits

There is a need to provide employees and self employed persons with a meaningful tax incentive to work and save. This can be done through the superannuation system or outside of it. *Outside the superannuation system* there already exist powerful tax incentives to work and save including, amongst others:

- ✓ The 50% capital gains tax discount;
- ✓ Imputation credits on franked shares and imputation funds;
- ✓ Deductible interest costs from margin lending and borrowing for investment property;
- ✓ Tax free and tax deferred property trust distributions;
- ✓ The tax exemption for a taxpayer's principal place of residence; and
- ✓ The small business capital gains tax exemptions.

The above tax incentives, while they remain will always take the shine from investing in superannuation due to lack of accessibility in superannuation. The only real superannuation incentive to date with superannuation has been the ability for employees to salary sacrifice and self employed persons to obtain a contribution deduction - subject to age based limits. Making superannuation tax free post age 60 is an incentive for a 58 year old but not for those younger. By putting in place a 30% tax surcharge on contributions over $50,000 this will act as a strong disincentive to making voluntary superannuation contributions. People will invest outside of superannuation in tax subsidised investments that are accessible.

In addition the administrative arrangements to implement the proposals are cumbersome and will increase Government costs through complex upgrades to ATO computer systems, increased ATO manpower to determine and audit the new surcharge as well as make public rulings on the subject. Additionally trustees of a SMSF will face significant administration costs to comply with the proposed administration system.

SMSF Strategies submits that the current age based deduction limits remain in force but with a limit of $50,000 for any employee or self employed person below aged 50 and $120,000 for those above age 50. These limits should be indexed to AWOTE.

Submission 10: Administrative alternative

SMSF Strategies submits that the proposed surcharge style system is administratively complex. An alternative is to treat all employer and self employed deductible contributions as taxable contributions under section 274 of the Income Tax Assessment Act 1936. However a change in the Income Tax Rates Act 1986 be made such that taxable contributions above $50,000 for those under age 50 are taxed at 30% (the old surcharge rate not the proposed 45% rate). The current rate would provide sufficient disincentive as it was seen with the previous 15% surcharge. In addition to ensure that over 50's have the ability to obtain a reasonable superannuation benefits balance by their retirement a permanent $120,000 threshold for those over age 50 must be implemented. The thresholds should be indexed to AWOTE.

6. Changes to pensions

6.1 Simpler Super Reforms

The Simpler Super Reforms propose the following in terms of pension reform in a complying superannuation fund:

> "The decision to take a pension has in the past been a daunting prospect for many retirees, as different pensions can have different tax treatments and thus produce different retirement income results. In addition, the market's ability to meet consumer demand has been constrained by restrictions that limit flexibility and reduce choice.
>
> Under the proposed arrangements, all pensions that meet simplified minimum standards would be taxed the same on payment. Earnings on assets supporting these pensions would remain tax exempt.
>
> Pensions that meet existing rules and commenced before 1 July 2007 would be deemed to meet the new minimum standards.
>
> **The proposed simple standard**
>
> The new minimum standards for pensions commencing on or after 1 July 2007 would require:
>
> • payments of a minimum amount to be made at least annually allowing pensioners to take out as much as they wish above the minimum (including cashing out the whole amount);
>
> • no provision to be made for an amount to be left over when the pension ceases; and
>
> • *that the pension could be transferred only on the death of the pensioner to one of their dependants or cashed as a lump sum to the pensioner's estate.*
>
> The payment rules would specify minimum limits only. No maximum would apply, with the exception of pensions which are commenced under the transition to retirement condition of release."

5.3 SMSF Strategies submissions

SMSF Strategies welcomes the pension proposals for their simplicity and flexibility in design and makes the following submissions.

Submission 11: Abolish pensions

The Simpler Super Reforms propose that a member may retain a lump sum or pension account until their death. Once over age 60 there is no tax difference between pensions and lump sums. The only difference is the tax treatment inside the superannuation fund.

SMSF Strategies submits for the sake of simplicity the Government should abolish all pensions. In terms of the taxation of the fund, it should rest between the lump sum and pension rate of tax – 7.5%. For taxable contributions a tax rate of 15% would continue to apply.

Submission 12: Allow lump sums to non-dependents and the legal estate

Under section 62 of the SIS Act 1993, the trustee of the fund may pay a benefit to a dependant or the trustee of a deceased member's legal estate. The definition of dependant in section 10(1) includes the spouse and child of the beneficiary as well as anyone who is in an interdependent relationship with the member.

In contrast the definition of dependant for death benefit purposes in section 27A(1) of the Income Tax Assessment Act 1936 includes a spouse, former spouse, any child under the age of 18 plus anyone who is in an interdependent relationship with the member.

In the pension section of the detailed Simpler Super Reform paper at page 21 it states that on the death of a pension member, the pension may only be cashed as a lump sum to the member's estate. In contrast, the death benefit section at page 49 states that on the death of a pension member, the pension may not revert to the non-dependent and must be cashed in favour of the non-dependent. Which one is correct?

SMSF Strategies submits that in the event of the death of a pension member that it may be cashed in favour of a dependent or the member's legal estate, revert to a dependent or the member's legal estate or paid as a lump sum to a non-dependent only.

Submission 13: Define reversionary pension

The Simpler Super Reforms state in terms of death benefits that:

> "The taxation of death benefit payments as a reversionary pension would depend on the age of the primary and reversionary beneficiary. If the primary beneficiary was aged 60 or over on death, then payments to the reversionary beneficiary would be taxed at marginal tax rates less any deductible amount and less the 10 per cent offset (which would have been the tax treatment applying to the primary beneficiary before death).

> If the primary beneficiary was under age 60 at death, the pension would continue to be taxed at the reversionary beneficiary's marginal tax rate (less any deductible amount), unless the reversionary beneficiary is aged 60 or over, in which case the 10 per cent offset would apply. A pension would not be able to revert to a non-dependant on death; rather, death benefit payments to non-dependants would have to be made as a lump sum."

The concept of a reversionary pension is an important one under the current laws as well as the Simple Super Reforms. However there is no guidance on what is a reversionary pension under the SIS Act 1993 or the Income Tax Assessment Act 1936. Accordingly is a reversionary pension a pension where:

> The nominated beneficiary is known up front so that on the death of the member the reversionary beneficiary takes over the pension under the same terms and conditions; or
>
> Once the member dies and monies are left over in the pension member's account, any reversionary beneficiary who is a dependent may commence a pension. The new pension is a reversionary pension.

SMSF Strategies submits that a definition of the terms reversionary pension and reversionary beneficiary be included in the SIS Act 1993 and the Income Tax Assessment Act 1936.

* * * * *

SMSF Strategies thanks the Government for the opportunity to make the above submissions and awaits the outcome of the Simpler Super Reforms. Should you have any queries regarding the above please do not hesitate to contact me at smsfstrategies@yahoo.com.

Yours sincerely

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