Dear Sir/Madam

CAPITAL GAINS TAX ROLL-OVER FOR COMPLYING SUPERANNUATION FUNDS WITH CAPITAL LOSSES

We refer to the above Treasury Discussion Paper (the discussion paper) that was issued on 16 January 2009 following the 23 December 2008 announcements made by the Minister for Superannuation and Corporate Law, Senator the Hon Nick Sherry MP. In his announcement, the Minister indicated that capital gains tax (CGT) roll-over would be provided for capital losses arising under a complying superannuation fund’s merger with an APRA-regulated complying superannuation fund with at least 5 members from 24 December 2008 to 30 June 2010 (inclusive).

Following our review of the discussion paper, we provide our comments on a number of matters which should be considered. The relevant matters have been listed below and explained in detail in the following attachment:

1. Complexity of the Proposed Arrangement
2. Pre-merger realised capital gains tax losses
3. Extension of the roll-over relief to other superannuation entities
4. Extension of the roll-over relief to other rationalisation activities within the industry
5. Permanent Rollover Relief
6. Tax cost base adjustment of the receiving funds assets with exempt pension income
7. Interaction with other provisions of the 1997 Act
8. Extension of rollover relief to other assets held by superannuation entities
We trust that the attached comments are clear. Should you have any queries or require any assistance, please contact me on (03) 9208 6600.

Yours sincerely

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The purpose of the proposed capital gains tax rollover relief is to facilitate the merger of superannuation funds and consolidation within the superannuation industry and therefore improving economies of scale and enabling the more efficient provision of services to members. We are concerned that the proposals as outlined are unlikely to facilitate mergers for a number of reasons as outlined below.

1. Complexity of the Proposed Arrangement

   Based on the discussion paper, transferring funds will be able to ‘cherry-pick’ the assets which are to be subject to the proposed CGT rollover relief. This is unlike any previous CGT rollover relief that has been available in the past for superannuation funds.

   Because funds are able to cherry-pick the assets which are rolled over, funds will need to review the tax position for each and every assets which is transferred and determine the taxable position of those assets and then make decisions regarding which assets are to be rolled over and which ones are not.

   In addition, transferring funds will be required to make cost base adjustments in relation to their assets which are rolled over to reflect the exempt pension methodology used by the transferring fund to determine its exempt pension income (if any).

   We are concerned that while the ability to cherry-pick provides transferring funds with the ability to optimise the assets which are rolled over, it creates uncertainty for the receiving fund in relation to any decisions it needs to be make in relation to those rolled over assets which take into account the after-tax returns on those assets.

   For example, many funds have standing instructions requiring asset disposals to been done in such a manner as to optimise the after-tax returns on the disposals on their assets. Unless there is certainty regarding the cost base of a particular asset at the date that relevant decisions are being made, the receiving fund can only make certain assumptions regarding what they believe the transferred cost base will be until the final tax position of the transferring fund is determined.

   Because funds are able to cherry-pick the assets which can be rolled over, it will be necessary for the transferring funds to take into account a number of factors which may not be known at the date of merger and may not be finalized until the final income tax return of the transferring fund is
completed. This is because the trustees have a fiduciary duty to act in the best interests of all their members and therefore need to consider the after-tax implications of their cherry-picking decisions.

For example, the transferring fund may have received trust distributions in its final period of operation. Those trust distributions may include capital gains amounts which would ordinarily be offset against the capital losses of the superannuation fund. If the transferring fund elects to rollover certain assets prior to establishing the capital gains flowing through its trust distributions, the transferring fund may be paying tax on these distributions that it would not otherwise have been paying tax on. In addition, these distributions may have tax deferred amounts included in them which should be adjusted against the cost base of the relevant units.

Another example relates to the adjustments required in relation to exempt pension income of the transferring fund. Where funds use the current pension liability method to determine their exempt pension income, this current pension liability percentage may not be determined until well after the end of the period to which the percentage relates. This is because the percentage is based on the average current pension and superannuation liabilities during the period. Therefore, at the date of merger, this percentage may not be known or finalised.

To provide greater certainty for the receiving fund, consideration should be given to simplifying the rollover rules. It would be more appropriate for transferring funds to be able to rollover all their assets rather than just their assets carrying unrealised CGT losses. This would be consistent with prior CGT rollover provisions that have applied to super funds and reduce the complexity and uncertainty associated with the proposed rollover mechanism.

We note that the proposed cherry-picking of losses may create equity issues for superannuation funds from a unit-pricing/crediting rate perspective where they need to determine how the tax impact of the proposed rollovers should be shared amongst the members. This is because the CGT loss rollover relief is applied at fund level from a cash/asset perspective while the benefits of the carried forward losses and the cash savings associated with offsetting capital losses against capital gains needs to be determined at member level. For example, as a result of a merger some investment options may benefit from use of capital losses that would have otherwise been applied against capital gains of another investment option had the fund remained as a stand-alone fund. The transferring fund would need to determine whether this is appropriate at member level or whether there should be additional adjustments made at member level to transfer the all/some of the benefit of the tax savings on the offset capital gains to the other members within the fund. The complexity of these equity issues which will arise of the ‘cherry-picking’ system should not be under-estimated.

To encourage merger of superannuation funds, the rollover rules should be as simple as possible to implement. Ideally, the CGT rollover rules should provide that all assets of the superannuation fund can be rolled over regardless of whether the assets have gains or losses attached to them.
2. **Pre-merger realised capital gains tax losses**

We note that under the proposed CGT rollover provisions that the value of any CGT losses realised by the transferring fund prior to the merger of that fund will be lost. That is, if there are insufficient merger capital gains available to offset pre-merger realised CGT losses, these losses cannot be transferred to the receiving fund. In this case, the value of these losses will prima facie be lost to the transferring members resulting in a decrease in the members benefits as a result of the merger.

Unlike prior temporary CGT rollover periods for superannuation funds, many funds that are considering merger already have significant realised CGT losses available to them. It is unlikely that these funds would have sufficient realised capital gains on merger that would offset these capital losses.

Consideration should be given to enabling superannuation funds to transfer the unused pre-merger realised capital losses to the receiving fund so that adverse tax outcomes do not become a major driver for decisions regarding fund mergers. This is because any decisions which adversely impact upon members benefits are major factors that trustees must consider. We believe that allowing such a transfer is consistent with the proposed CGT rollover relief which is designed to facilitate fund mergers so as to lead to improved economies of scale including cost effective services which ultimately leads to better returns for superannuation members.

Under this approach, this would mean that a fund’s net CGT loss position could be rolled over as it would avoid there being a non-transferrable CGT position within a fund that could be an impediment to the merger of superannuation funds.

3. **Extension of the roll-over relief to other superannuation entities**

The proposed roll-over considers the merger of a complying superannuation fund with another complying superannuation fund with at least five members (ie. a large superannuation fund). We submit the roll-over should also be available for other superannuation entities which may also be merging to lead to improved economies of scale including cost effective services which ultimately leads to better returns for superannuation members.

For example, pooled superannuation trusts (PST) as defined in section 48 of the *Superannuation Industry (Supervision) Act 1993* that may wish to merge with another PST but may be faced with the same barriers that the Rudd Government is keen to remove for complying superannuation funds to help achieve cost efficiencies.

Primarily, PSTs are taxed in the same manner as complying superannuation funds and under the same Part and Division of the *Income Tax Assessment Act 1997* (the ITAA 97). The tax concessional treatment available in Division 295 of the ITAA 97 is available to PSTs as both superannuation funds and PSTs are intended to encourage Australians to save in order to make
provision for their retirement, recognising that superannuation investments and the income from them are quarantined for retirement.

PSTs have been included in Division 295 in recognition that PSTs provide the superannuation industry with the opportunity to access improved economies of scale which ultimately leads to better returns for superannuation members. This is because PSTs have enabled superannuation funds to pool their investments through the PSTs to access investments that they could not have accessed by themselves or to gain economies through a ‘shared’ investment function. As Division 295 is written to encapsulate “superannuation entities”, as such any CGT roll-over relief should include all superannuation entities affected by mergers of superannuation entities.

PSTs are accepted and commonly used by superannuation funds as investment vehicles and effectively they own assets which ultimately are the assets of superannuation fund members. To not allow CGT roll-over for PSTs who merge with another PST is ultimately affecting the superannuation members that the roll-over relief outlined in the discussion paper is trying to protect.

It should be noted that any mergers of superannuation entities will result in less superannuation entities that the Australian Prudential Regulation Authority (APRA) has to monitor and regulate. Additional efficiencies can be gained within the superannuation industry as a result of such mergers and potential reduction is regulatory costs and supervision.

4. Extension of the roll-over relief to other rationalisation activities within the industry

Rationalisation within the superannuation industry can take on a number of forms and may not be limited to just complying superannuation funds merging with another complying superannuation fund. In all instances, it would be expected that the mergers are occurring to lead to improved economies of scale to gain cost efficiencies which ultimately mean better investment returns and more cost effective services to superannuation members. In addition, such mergers mean that there are fewer superannuation entities for APRA to regulate.

For example, two large superannuation fund may be wish to obtain some economies of scale and access to investment markets that as stand-alone entities they are unable to achieve/access. This may be for a variety of reasons such as:

- the sponsoring employers not agreeing to a fund merger for a numerous of reasons or
- other logistical reasons such as loss of identity which could lead to loss of membership which would defeat the objective of achieving economies of scale.

In such an instance, the funds may consider merging their investment activities into a PST which one or the other may currently own or as a newly established PST.
Where the investment functions of the two funds are merged, there are clearly economies of scale to be achieved by the two funds. Similarly where one fund already has a PST which operates the investment function of that superannuation fund and the second fund wished to merge its investment function into that PST, economies of scale can be achieved. As with merging superannuation funds, the tax consequences of such a merger could be a significant barrier to the merger of the superannuation investment activities leading to lost economies of scale, increased costs to members and reduced investment earnings to members.

The CGT roll-over announced by the Government should apply to all “superannuation mergers” which achieve the Government’s aim of improving the economies of scale and enabling the more efficient provision of services to members. For example, in the above example, the members of the merging fund would clearly benefit from the economies of scale. A condition of the availability of the CGT rollover relief to the large superannuation fund and the PST could be that the merging fund should hold no other assets other than the PST units and appropriate bank accounts to meet its day-to-day obligations including its pension’s obligations.

5. **Permanent Rollover Relief**

Since taxation of superannuation funds was introduced in 1988, temporary superannuation CGT rollover relief has been introduced a number of times. Each time that rollover relief has been introduced for the superannuation industry, it has been for the purpose of enabling superannuation funds to consolidate and improve economies of scale.

As stated in the discussion paper, industry consolidation can assist the industry by improving the economies of scale and enabling the more efficient provision of services to members. However we submit that limiting the roll-over relief to mergers on and after 24 December 2008 and before 1 July 2010 limits the potential consolidation that may be needed to strengthen and support the industry.

Fund trustees need to be supported in their role to fulfill their fiduciary obligations and make decisions in the best interest of their members. Tax inefficiencies should not be the prime driver for a trustee to make a decision for their fund to merge/not merge with another fund.

By allowing the CGT roll-over relief for superannuation entity mergers to apply as a permanent exemption within the CGT provisions, the Government would be supporting the role of the trustee and the important decisions that they make by ensuring that tax is not the main deterrent for making/not making a decision to merge.

In addition, the number of times that CGT rollover relief has been introduced for superannuation supports the fact that CGT rollover relief should be permanently available for superannuation entities. Otherwise, superannuation entities are likely to defer mergers until the next round of temporary relief provided for superannuation entities. Alternatively, where the superannuation
entities proceed with the merger, the members are disadvantaged by the timing of the merger if it does no coincide with the temporary relief.

It should be noted that temporary rollover relief could lead to some trustees making key decisions in a rushed fashion and the relevant mergers may not occur in an orderly manner where the trustees are just considering their future state and merger options.

6. **Tax cost base adjustment of the receiving funds assets with exempt pension income**

The discussion paper indicates that modified CGT rollover relief rules will apply in respect of any assets which are transferred under the CGT rollover relief provisions which have been used to support current pensions of the transferring fund.

In relation to segregated current pension assets, these assets will not be able to be rolled over and therefore the losses on the assets will be foregone as a result of the merger. This is because these assets are not subject to capital gains tax under the current segregated pension asset rules.

Where the current pension liability method is used by the transferring fund, the cost base of the rolled over assets is to be reduced to reflect the transferring fund’s current pension liability percentage.

In both instances, this assumes that there is symmetry between the exempt pension income positions of both the transferring fund and the receiving fund. That is, the asset will continue to be tax exempt in the receiving fund to the same extent that the asset would be have been exempt had it remained in the transferring fund. It is extremely unlikely that this will be the case. Where the funds use the current pension liability method, it is in fact more likely that transferred asset would become ‘more taxable’ in the receiving fund as there is a reasonable expectation that the receiving fund will have more accumulation benefits compared to pension benefits. Where the transferring fund treated the asset as a segregated asset, it is unlikely that the receiving fund will continue with this practice as most large funds do not segregate their assets for exempt pension income purposes unless those assets are PST units in which case those PST units are exempt from CGT regardless of whether they are segregated pension assets or not.

If there is a requirement that to make a cost base adjustment to reflect the pension position of those assets, consideration should be given to requiring the receiving fund determining the cost base adjustment required based on the exempt pension income position of the merged fund. This will achieve greater equity between all members and will not penalise transferring pension accounts for any adverse tax consequences arising from cost base adjustments in the transferring fund.
We note that where the current pension liability method is used, it is the net capital gain which is included in the fund’s assessable income that is adjusted for the exemption pension income purposes and not the gross capital gain followed by an adjustment to the capital losses. That is, under the CGT rules, the full value of any realised losses regardless of the current pension liability percentage of the fund is offset against the gross capital losses of the fund. This net CGT gain is then discounted where applicable and then the current pension liability percentage is applied against the net assessable CGT amount. The proposed cost base adjustment is therefore inconsistent with the current CGT provisions and are detrimental to all members of the fund and not just the pensioners.

We also note that under previous CGT rollover periods, cost base adjustments have not been required in respect of the exempt pension income of the transferring fund.

7. Interaction with other provisions of the 1997 Act

The discussion paper outlines that the assets subject to roll-over relief will be taken to have been acquired by the receiving fund at the same time as the asset was acquired by the transferring fund, for the purpose of applying the CGT discount to a subsequent CGT event to the asset.

The acquisition date of the asset for the transferring fund also needs to be acknowledged for other holding period rules within the tax legislation, for example the holding period rule in section 160APHO(2) of the 1936 Act in relation to the 45 day rule as ‘imported’ into the 1977 Act (refer to TD 2007/11).

8. Extension of rollover relief to other assets held by superannuation entities

By their very nature, superannuation entities hold a variety of asset for investment purposes. However, the tax legislation specifies how those assets are to be treated for income tax purposes and while CGT is the primary code for the taxation of a superannuation entity’s assets, there are assets which are taxed as ‘revenue’ assets because of specific taxation provisions even though the entity’s purpose for holding those assets is the same as the CGT assets.

Given that the proposed rollover methodology limits the rollover relief to assets carrying CGT losses, rollover relief should also be available in relation to assets which are subject to the revenue provisions (for example, traditional securities).

Given that this is the first time that CGT rollover relief has been limited to loss-bearing CGT assets, it is appropriate that rollover relief should be provided to other assets held by the superannuation entities. This acknowledges that funds will be able to cherry-pick CGT assets that the rollover relief
is to be applied and provides equity between the various assets held by the superannuation entities. It would also reduce confusion regarding what assets held by a superannuation entity will be subject to rollover relief.

We note that under the current taxation legislation the superannuation business of two life insurance companies can be merged under Part IX of the Life Insurance Act and effectively have rollover on both revenue and capital assets. This precedent should be taken into consideration in relation to this issue.