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PRIVATE & CONFIDENTIAL

Mr T Thomas
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Dear Trevor

Superannuation Contribution Caps

At the last NTLG (Superannuation) meeting in September 2009, the group discussed the difficult issue of the limits which apply to both non-concessional and concessional superannuation contributions.

At the time, you expressed some interest in practical examples of situations where the contributions cap regime has resulted in what would appear to be an unjust outcome.

To that end, I have set out below a range of examples that have arisen in our practice which I believe might be of interest. The theme which emerges can be summarised as follows:

- the Government is clearly well within its rights to impose limits on superannuation tax concessions and this letter does not comment on this broad policy issue
- it is also reasonable to suppose that where Government chooses to impose a limit on any tax concession, the taxpayer must face some financial cost (be it a penalty, additional tax, loss of tax deductions etc) where the limit is exceeded; but
- it would appear that in the particular case of the contribution caps applied under Section 292 of the Income Tax Assessment Act 1997 (ITAA 1997), the 'punishment' meted out to those who exceed their cap (ie, excess contributions tax) is often out of proportion to the 'crime' (ie, the extent to which the relevant limit was exceeded and the reason the limit was exceeded).

It is this final point that I have sought to explore in this letter using various examples.

Note that for the purposes of all these examples, I have assumed that the \$25,000 concessional contributions cap applies (ie, the member is under 50).

Case 1 – Failing the ‘10% test’

As you know, taxpayers are able to claim a personal tax deduction for their superannuation contributions, providing they meet a test set out in ITAA 1997 Section 290-160(2). This test is often referred to as the ‘10% test’.

Consider the case where a taxpayer is initially running a small business as a sole trader. During the year, he makes superannuation contributions on the basis that the 10% test is currently being met. He contributes \$475,000 intending to claim a personal tax deduction for \$25,000. He lodges all relevant notices, is issued with an acknowledgement from the fund trustee etc.

During the year, he winds up his business and secures a job – the outcome of which is that he ultimately fails the 10% test and is not able to claim a personal tax deduction for his superannuation contribution.

As a result, he has excess non-concessional contributions of \$25,000 and these are taxed at 46.5%. In other words, not only has he failed to secure a tax deduction that he had anticipated but he must also pay 46.5% tax on his \$25,000.

I should highlight here that in my view, the inequity does not lie in the fact that the taxpayer is *unable to claim a tax deduction* because a change in circumstances has caused him to fail the 10% test. Many provisions in Australia’s tax system revolve around thresholds, eligibility tests etc. Taxpayers who fall \$1 within the threshold (say) or meet the relevant test receive a vastly different tax outcome to those who fall \$1 outside the threshold or fail the test, even though their shortfall / failure is caused by a very small amount.

While this type of system may appear arbitrary and punitive to an observer, it is nonetheless a common feature of our tax law and is therefore presumably considered by policy makers to be an acceptable way of limiting access to tax concessions. Viewed in that context, the fact that the taxpayer in this example will be unable to claim a tax deduction due to an unforeseen change in circumstances is entirely consistent with other areas of tax law.

What is different in the contributions cap arena is that the taxpayer not only fails to secure a concession (a deduction for contributions in this case) but also suffers an **additional** penalty – excess contributions tax.

A change in circumstances (quite possibly beyond the taxpayer’s control) has therefore resulted in a very significant financial cost. In the legislation that applied before 2007, the only consequence to the taxpayer would have been failure to secure a tax deduction.

Case 2 – Lower than expected taxable income

A similar outcome would arise if the same taxpayer **was** able to meet the 10% test but had less than \$25,000 in assessable income. Say, for example, his assessable income was only \$15,000.

In this case, his concessional contributions would be limited to \$15,000. The additional \$10,000 would ultimately be checked against his non-concessional contributions cap and found to be excessive – resulting in 46.5% tax.

Again, while it would seem entirely reasonable for there to be some consequence to this mistake / change in circumstances, the penalty is significant relative to the mischief.

Case 3 – Inadvertently triggering the three year ‘bring forward’ rules

Some of our most dramatic illustrations of inequities in the contributions cap regime manifest themselves when we take into account the provisions of ITAA 1997 Section 292-85. It is this section that allows certain taxpayers to ‘bring forward’ the following two years non-concessional contribution limits and contribute up to \$450,000 in a single year.

The table below sets out just one illustration of a client situation where a small mistake resulted in a very significant tax penalty.

	Concessional contributions	Non-concessional contributions
2007/08	\$55,000	\$150,000
2008/09	\$25,000	\$450,000

At first glance, this client has simply exceeded the concessional contributions cap in 2007/08 (by \$5,000) and should therefore expect some penalty. The actual outworkings of the legislation, however, produce the following result:

- the excess concessional contribution of \$5,000 is taxed at 31.5% (\$1,575);
- it also counts towards the non-concessional contributions cap and accordingly the total counting towards this limit in 2007/08 is \$155,000;
- as this amount exceeds the yearly limit of \$150,000, the taxpayer is considered to have ‘locked in’ a three year period (1 July 2007 – 30 June 2010) in which he can make up to \$450,000 in non-concessional contributions;
- in fact, \$605,000 (\$155,000 in 2007/08 plus \$450,000 in 2008/09) will be assessed against his non-concessional contributions limit over that period;
- the excess is therefore \$155,000 (\$605,000 - \$450,000) – resulting in a further tax penalty of \$72,075.

In other words, a \$5,000 mistake in 2007/08 has resulted in a penalty of more than \$70,000!

While it is certainly reasonable for there to be some consequence to exceeding the concessional contributions cap in 2007/08, this outcome again seems out of proportion.

Bear in mind also that the original \$5,000 excess could have been as little as \$1. Common sources of this excess have included:

- simple errors (miscounting the amount contributed during the year to date);

- small employer contributions made as a result of short term work that were not factored into the taxpayer's calculations;
- employer payments to a superannuation insurance policy (which are technically contributions to superannuation and must be reported as such).

In each case, sound knowledge of the law and careful arithmetic would have avoided the problem. This letter is not intended to suggest that such things should be overlooked completely. Rather, it is my contention that the consequences of small errors are disproportionately large and is surely an unintended consequence of this legislation.

In some circumstances, taxpayers are unable to take action to avoid excess concessional contributions. For example:

- a taxpayer might have two employment arrangements, both of which involve compulsory membership of a particular superannuation fund with prescribed levels of employer support. It is entirely possible that his employer contributions to the two funds (when added together) exceed the cap;
- even worse, taxpayers with several jobs where the combined value of their employer contributions under the Superannuation Guarantee (Administration) Act exceeds the concessional contributions cap. For example, a 45 year old taxpayer who has two positions each paying \$150,000 will receive \$27,000 (combined) in compulsory contributions. There is no longer any means of opting out of Superannuation Guarantee contributions. This possibility was raised in a submission from industry at the last NTLG meeting (Agenda Item 6.6, meeting of 8 September 2009) and the ATO confirmed that in their view, the law does not provide scope for the Commissioner to exercise his discretion under ITAA 1997 Section 292-465 to disregard or re-allocate the contributions.

Is it consistent with government policy for taxpayers in this position to suffer such penal rates of tax?

Case 4 – overseas transfers

The issue here is slightly different but it is nonetheless worth considering in the context of this letter.

As you are no doubt aware, particular tax treatment applies when amounts in foreign superannuation funds are transferred to an Australian fund. You will also be aware from previous discussions at the NTLG that the interaction of:

- the law governing foreign transfers (Sections 295-300 & 305-80 ITAA 1997);
- the contribution caps set out in Division 292 ITAA 1997; and
- the fund capped contribution rules in SIS Regulation 7.04(3)

simply does not work.

The special concessional tax treatment for overseas transfers only applies where the member transfers his or her entire interest in the foreign fund to the Australian fund.

If the amount involved is large enough, this can be frustrated by the fund capped contribution rules – ie, the fund cannot accept the entire transfer amount. Thanks to the fund capped contribution limits, the taxpayer cannot even simply elect to pay the excess contributions tax, rather the transaction cannot occur at all.

This has resulted in ridiculous devices such as dividing an individual's superannuation in its country of origin (say a taxpayer might split his UK entitlements into two funds within the UK and then transfer one at a time to Australia).

Again, while the Government may well feel it appropriate to limit the amount being transferred from foreign funds to our own superannuation system, there must surely be a better means of achieving this objective.

Is there a solution?

Given that there must be some consequence to exceeding contributions caps, it would appear that there are essentially two options:

- additional taxes; or
- compulsory action such as forced refund of contributions.

When the changes to superannuation were first announced in the May 2006 Federal Budget, the Government's intention was to adopt the latter approach (excess contributions were to be refunded with interest and that interest was to be taxed at the highest marginal income tax rate).

Presumably practical difficulties with such a system contributed to a change of heart – most of the 'stick' associated with excess contributions now comes from additional taxes. However, it seems a bit ridiculous to impose such penalties on individual taxpayers just because the superannuation industry was going to find it difficult to monitor and comply.

While contributions must be refunded under certain circumstances (the fund capped contribution limits) these have only limited application. (For example, they only apply on a transaction-by-transaction basis and provide no protection against exceeding caps as a result of several transactions in a single year or three year period.)

In my view, the system would be vastly improved – and some of the weaknesses highlighted in this letter would be addressed – if the Government's approach changed here. I recognise that this would require changes to the law and that this is always problematic but I believe quite strongly that the particular way we currently impose the contribution caps risks becoming a significant flaw in an otherwise vastly simplified system.

Note that not all of my suggestions here are mutually exclusive – the Government could certainly consider a combination of changes.

1. Voluntary refunding of contributions

Given the problems we have with the current system, I believe the Government should revisit the original proposed solution to contribution caps – removing the excess from the fund (ie, refunding the offending contributions).

It would be reasonable to impose time limits on the process (which provides a disincentive to deliberately over contribute and/or delay returning the contributions) and it might even be appropriate to give the ATO discretion to prohibit the refund for repeat offenders. However, it would certainly enable those who make small mistakes and who quickly discover and rectify them to escape serious penalty.

If it is considered administratively difficult for the funds involved, it could perhaps be offered on an 'opt in' basis (ie, it is not compulsory for funds to use this concession but they are permitted to do so if they wish). Market forces would then drive most funds into adopting some method of repatriation.

2. *Combined limits*

The current limits clearly contemplate an individual having superannuation contributions of up \$175,000 pa (\$150,000 non-concessional and \$25,000 concessional). This makes the outcome of Case Studies 1 and 2 particularly harsh – the taxpayer contributed the right amounts but because he or she was not able to classify enough / any of the amount as concessional contributions, an excess arose.

This could be avoided by allowing taxpayers a single dollar limit of \$175,000 pa – to be divided between concessional and non-concessional as they wished, subject to a maximum concessional contribution of \$25,000.

3. *Voluntary payment of excess contributions tax in the 'wrong' year*

To my mind, Case Study 3 presents the most dramatic illustration of a situation where a small mistake resulted in a disproportionate penalty. It is also not a theoretical example, it is something I have seen arise in practice more than once.

A fairer system would allow the taxpayer to elect to pay excess contributions tax in 2007/08 when the \$5,000 error occurred and in doing so specifically choose **not to** "bring forward" the three years' worth of non-concessional contributions cap. This automatic trigger of the three year cap rule is one of the most iniquitous and perverse aspects of the entire system.

Even if 93% tax was levied on that amount (on the basis that it caused the member to exceed both caps), the net result would be a vastly lower tax bill (\$4,650) than the \$70,000 penalty highlighted above.

It would still, in my view, be consistent with Government policy of limiting access to superannuation – remember the taxpayer did not exceed his caps to a significant degree overall, he simply got the timing wrong. Had he, for example, contributed \$50,000 concessional contributions in 2007/08 but \$30,000 in 2008/09 (ie, the same \$5,000 excess but in a different year), the penalty would have been \$4,650.

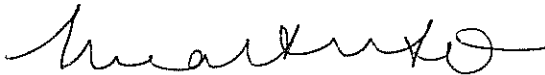
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Trevor, I realise that the discussion at the last NTLG meeting really centred on a particular issue (a taxpayer who exceeded his concessional contributions cap due to compulsory SG contributions) and you invited comments on that rather than the system as a whole. You may also have been aware of many of the issues raised by my four case studies already. Nonetheless, I believe it is important that any changes made to the contributions cap system do not focus purely on one patently unfair aspect but

rather look at the inequities of the system as a whole. I hope my broader response is useful in that context.

Excess contribution cap taxes are unlikely to affect the vast majority of taxpayers but those it does affect are (in my view) treated quite inequitably. I would be happy to flesh out some of my suggested solutions further if that would be of interest to you.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Meg Heffron', with a stylized, cursive script.

Meg Heffron
Principal