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Submission to Australia's Future Tax System Review

MERCER

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INTRODUCTION AND EXECUTIVE SUMMARY

1.1. WHO IS MERCER?

Mercer is a leading global provider of consulting, outsourcing and investment services, with more than 25,000 corporate and trustee clients worldwide. Mercer consultants help clients design and manage retirement, health and other benefits and optimise human capital. The firm also provides customised administration, technology and total benefit outsourcing solutions. Mercer's investment services include global leadership in investment consulting and multi-manager investment management.

In Australia, Mercer's outsourcing services include an integrated service platform for 320 superannuation plans, 600,000 members and private clients with $35 billion in assets under administration.

1.2. TERMS OF REFERENCE

Mercer's submission concentrates on superannuation and related issues and how these interact with the tax and social security systems.

In relation to the Tax Review's Terms of Reference our submission deals with issues relative to:

3.1. The appropriate balance between taxation of the returns from work, investment and savings;

3.2. Improvements to the tax and transfer payment system for individuals and working families, including those for retirees;

3.3. Enhancing the taxation of savings, assets and investments;

3.5. Simplifying the tax system.

Our comments and recommendations take into account:

- Australia's ageing population and increasing longevity which will have major implications on financing Social Security costs and lifestyles in retirement

- the importance for employers and the overall economy of retaining older employees in the workforce.

Mercer's submission concentrates on actions that need to be taken so that Australia can provide its citizens with an appropriate level of income in retirement on a sustainable basis and without unduly high taxes being applied to the working age population.

In September 2008, Mercer made a submission to the Harmer Pension Review which considered in detail many issues which are also relevant to the Tax Review. Rather than repeating the arguments in this submission, we have attached a copy of our Pension Review submission as Appendix 1. However, for completeness, the Executive Summary below includes the major points and recommendations from our submission to the Harmer Pension Review as well as the new points raised in this submission.

1.3. EXECUTIVE SUMMARY

1.3.1. Getting the retirement system structure right

Australia is facing a number of critical challenges with an ageing population, increasing longevity and a skills shortage.

Life expectancy at age 65 is now 18.3 years for males and 21.5 years for females. These are approximately 5 years longer than they were 40 years ago with the increasing trend continuing.

Population projections indicate that by 2037, 19% of the population will be over age 65 compared to 10% today.

Whilst the current economic downturn may provide some reduction in the demand for skills at the same time as older workers may be considering deferring retirement due to the diminution of their retirement savings, this is unlikely to be a long term phenomenon. We expect that Australia will continue to face skills shortages in the longer term.

It is therefore critical that the Tax Review look at an integrated approach to superannuation, the age pension and related taxes to ensure that there are appropriate incentives for the right behaviours. If the correct structure is not in place then the tax burden on employers and the working population may become too great leading to potentially disruptive outcomes.

Income during retirement is currently underpinned by a three pillar system made up of:

1. First pillar - the age pension

2. Second pillar - compulsory savings through the Superannuation Guarantee system

3. Third pillar - voluntary savings, including both superannuation and non-superannuation savings

Any decisions flowing from the Pension Review that relate to retirement saving need to take into account the interactions between each of these three pillars.

At its current level of about 25% of Average Weekly Earnings, the single age pension does not provide a level of income that would be considered acceptable by the majority of the population. However, as the age pension is only one of the three pillars, this is not necessarily inappropriate – it is the combined value of the three pillars that needs to be taken into account.

The Government needs to ensure that its policies are such as to deliver an appropriate total package of benefits under the three pillars.

It is worth noting that the latest OECD data which calculates net replacement rates (NRR) arising from mandatory pension programmes (ie age pension and Superannuation Guarantee for Australia) indicates that Australia is below the OECD average (Refer to Section 1 of Appendix 1). This highlights the need to encourage voluntary savings.

Our recommendations to address the needs of Australia and Australian retirees in the future concentrate on the need for sustainability and how the adequacy of retirement income can be improved by further developments of the second and third pillars and thereby reducing the reliance on the age pension.

1.3.2. Major Recommendations

In our view, there are several critical recommendations in relation to the tax and transfer system as they apply to financing our retirement system.

These are as follows:

1. Gradually increase the age pension age (refer to recommendation 1 below)

2. Provide more rigorous encouragement for 'voluntary' saving by introducing a form of soft compulsion (refer to recommendation 7(a) below)

3. Provide more financial assistance to lower and middle income earners in relation to superannuation savings. This could include providing a refundable tax offset to lower income earners in respect of employer contributions (recommendation 3(a)), and expanding the co-contribution limits (recommendation 7(c)).

These and other recommendations are set out in more detail below.

1.3.3. First Pillar – the age pension age

From a long term perspective, our major concerns relate to:

- the sustainability of the current age pension age as retirees are now spending a larger portion of their life in retirement and hence the cost to tax revenue is likely to increase;

- the lack of effective incentives to encourage ongoing participation in the workforce beyond age 65.

Recommendation 1: Increase the age pension age and provide greater incentive to those able to work past age pension age (Refer to Sections 2 and 3 of Appendix 1.)

a) Increase the age pension age gradually from 65 to 67 starting from 2025. Age 65 was first set over 100 years ago and has not been modified to reflect significant increases in longevity. An increase in this age would be consistent with changes made in a number of other developed countries. It would also encourage later retirement by those who are able to continue working. Those unable to work would be provided with either disability or unemployment benefits.

b) Replace the current pension bonus scheme (which we consider to be overly complex and inequitable) with a new system in which earnings from personal exertion (up to a specified level) would be excluded from the income test for those over age pension age. The mature age worker tax offset could also be removed from age pension age.

1.3.4. Second Pillar – Superannuation Guarantee

Our major concerns relate to:

- the significant gaps in the current system wherein many Australians are not currently provided with Superannuation Guarantee benefits for long periods of their pre-retirement life;

- the complexity and high compliance costs of the SG system for employers;

- the high penalties which apply under the SG system, even for minor and unintended breaches by employers. These penalties currently discourage reporting of breaches;

- the high level of tax on contributions in respect of low income earners.

Recommendation 2: Improve adequacy by removing some of the large gaps in the current coverage of the second pillar ie the Superannuation Guarantee system. (Refer to Section 2.2 of this submission and Section 4 of Appendix 1.)

This could be achieved by:

a) Gradually phasing the self-employed into the Superannuation Guarantee system.

b) Expanding the Superannuation Guarantee system to cover workers compensation benefits and paid parental leave.

c) Providing some form of additional Government assistance to the long term unemployed, disabled and carers (ie carers of young children, the sick and the aged) to make up for part of the Superannuation Guarantee these Australians do not receive.

d) Removing the exemption for employees earning below $450 a month.

Recommendation 3: Improve equity for low income earners. (Refer to Section 3.5)

This could be achieved by reviewing the application of the 15% contribution tax for low income workers. This could be achieved by:

a) Providing low income earners with a refund of any contribution tax either by a Government payment to the person's superannuation fund or a refundable tax offset directly to the person.

Recommendation 4: Reduce the complexity of the SG system for employers. (Refer to Sections 2.3 and 2.5)

A range of changes could be considered which would reduce complexity and costs for employers. Some examples of simplification would include:

a) Greater clarification of OTE should be provided in the legislation. In the longer term, the earnings base on which contributions are calculated should be extended to include all payments other than fringe benefits, superannuation contributions and expense reimbursements (instead of any increase in the 9% employer contribution rate).

b) Amending the legislation to treat contribution payments to an approved clearing house by the 28th day after the end of the quarter as satisfying the SG requirements.

c) Redesigning the SG Statements forwarded to the ATO to reduce the time taken for completion by employers.

d) Reconsidering the wording of various bilateral Social Security agreements which have provisions designed to avoid double superannuation coverage but which are often ineffective in achieving the stated aim when Australians are transferred overseas by their employer.

e) Providing exemption for a wider range of short term visitors who are employed by a related company overseas.

f) Reconsidering the changes proposed in the Temporary Residents' Superannuation Legislation Amendment Bill 2008 and the Superannuation (Departing Australia Superannuation Payments Tax) Amendment Bill 2008.

g) If the changes referred to in (f) proceed, they should be limited to future temporary residents to avoid an adverse retrospective tax increase.

Recommendation 5: Reduce the severity of penalties for not paying SG contributions by the due date. (Refer to Section 2.4)

Various issues which need to be considered are:

a) Basing the SG Charge on OTE rather than salary and wages.

b) Enabling employers to make an additional payment directly to the superannuation fund equating to late payment interest on any late contribution rather than paying this to the ATO.

c) Allowing late payments to a superannuation fund to be tax deductible to the employer where an appropriate late payment interest adjustment has been paid.

d) Removing the need for an employer to lodge an SG Statement with the ATO, subject to making the appropriate payment and interest to the fund within 12 months of the end of the relevant quarter.

Recommendation 6: Ensure that superannuation requirements of industrial awards do not reduce competition, increase employer costs and result in lower benefits to employees**.** (Refer to Section 2.6.)

Consideration should be given to removing the ability for default funds to be specified in industrial awards.

1.3.5. Third pillar – voluntary saving

Our major concerns are:

- The need for better education of workers and retirees which will highlight the need for voluntary saving. (Whilst this is clearly not a tax issue, appropriate knowledge is, nevertheless, an important part of any successful system.);
- The lack of any "compulsory" requirement for individuals to save for retirement;
- The appropriateness of current tax incentives which are too complex and could be better targeted.

Recommendation 7: Improve adequacy by providing further encouragement to voluntary saving. (Refer to Section 3 of this submission and Section 5 of Appendix 1.)

This should be encouraged by:

a) Introducing a soft compulsion strategy under which employers would automatically deduct superannuation contributions from the salary of new employees and from any salary increases for existing employees but with the employees having the option to opt out.

b) Better education of workers and retirees which will require the simplification of financial advice requirements so that Australians can be better informed of the level of saving they will need for an adequate retirement income. This includes the provision of compulsory projections of benefits at retirement and beyond.

Further means of encouragement which would also result in major simplification that should be considered include:

c) Increasing the upper income threshold at which the co-contribution cuts out to, say, $80,000, or the level at which the 40% tax rate cuts in.

d) Extending eligibility for co-contributions to those who earn less than 10% of their income from employment or business activity. To avoid abuse, the work test could be retained for those below age 18 and those who have reached age pension age.

e) Allowing all superannuation fund members to claim a tax deduction for their personal contributions (with appropriate limits) rather than having to arrange salary sacrifice programs. A refundable tax offset would be necessary for low income earners.

1.3.6. Other equity and simplification changes

Following the introduction of the Simpler Super changes in 2007, one of the major components of superannuation which has not been simplified is the tax treatment of death benefits. Under Simpler Super, the tax arrangements in respect of death benefits not only remain complex but have become more inequitable and are open to tax minimisation strategies.

Recommendation 8: Increase equity and reduce complexity in relation to death benefits. (Refer to Section 4)

Consideration should be given to:

a) Removing the tax on all lump sum superannuation death benefits;

b) Either removing the complex anti-detriment provisions from the superannuation system to offset the costs of removing the tax on death benefits or modify the requirements to enable the provisions to be utilised by all funds and extended to apply to those who are financially dependent on or in an interdependency relationship with the member;

c) Removing the tax on all lump sum death benefits paid by employers.

There are also many other issues flowing from the Simpler Super changes that are creating difficulties or are creating confusion due to a lack of clarity or perceived (but unannounced) changes in legislation as part of the rewording of the provisions when transferred to the Income tax Assessment Act 1997.

Recommendation 9: Reassess issues which have flowed from the Simpler Super changes. (Refer to Section 5)

Issues which are causing major concerns and which we consider should be reassessed include:

a) The application of the no-TFN tax to superannuation funds rather than the individuals concerned.

b) The treatment of transfers from overseas funds.

c) The calculation of notional contributions for defined benefit funds and related issues.

d) Whether it should be possible to make additional contributions to an existing pension.

e) The requirements to qualify for a defined benefit pension.

f) The lack of tax deductibility for certain employer contributions paid after an employee has terminated employment.

Other issues which remain unresolved with the ATO at present and need finalisation include:

g) The tax deductibility of disability insurance premiums.

h) The exemption from tax on investment income on assets backing current pension liabilities.

As many aspects of the superannuation system have been developed on a piecemeal basis, various provisions appear to be no longer necessary.

Recommendation 10: Reassess the ongoing need for certain existing features of the superannuation system. (Refer to Section 3.7.)

a) Consideration should be given to removing various provisions including for example, child contributions and eligible spouse contributions.

Recommendation 11: Provide greater encouragement for product rationalisation. (Refer to Section 5.9.)

a) Capital Gains Tax rollover relief should be available where superannuation funds merge.

1.3.7. Options in retirement

Many retirees are unable to adequately plan the draw down of their retirement savings due to the uncertainties surrounding their life expectancy as well as the investment income that will be earned on their retirement savings. Consideration needs to be given to how the Government can better assist the industry to better provide retirement products that will provide an income for life.

Recommendation 12: Assist in the establishment of new products that will enable retirees to plan their drawdown from their savings more effectively (Refer to Section 5 of Appendix 1.)

a) The Government should sponsor industry discussions to determine how the private sector could be much more involved in providing guaranteed lifetime income streams, including consideration of the necessary regulatory changes and the design of suitable Government securities that would enable the private sector to better match their liabilities.

2

SUPERANNUATION GUARANTEE and CHOICE OF FUND

2.1. Introduction

The SG system is an integral part of the tax and transfer system with the potential to provide a significant level of income in retirement. It is administered by the Australian Taxation Office under the Superannuation Guarantee (Administration) Act which is part of Australia's tax legislation.

Whilst contributions made to a superannuation fund are not themselves considered to be a tax, where contributions are not paid, there is a requirement to pay a specified amount plus various penalties to the ATO. Such payments, at least those which are not passed on to the relevant employee's superannuation fund are considered to be a tax.

Mercer strongly supports the SG system which has now been in operation for 16 years and will result in a sound retirement savings base for many Australians.

However, there are some basic problems with the system that need to be addressed. The main issues of concern with the basic SG system are:

1. It does not cover a significant proportion of Australians.
2. Compliance is too complex for employers in the areas of:
   - determining the contributions required
   - payment of contributions
   - reporting of breaches.
3. Penalties for minor and normally unintended breaches are too severe.
4. Various difficulties in relation to international workers (including Australian workers who are transferred overseas and for overseas workers temporarily working in Australia).

The actual benefits of Choice of Fund for many Australians are less obvious however the basic concept of an individual being able to choose a superannuation fund for their retirement savings is reasonable and should be supported. Nevertheless, the administration costs for employers in satisfying their requirements under Choice should not be underestimated. This has been considered as part of the cost of compliance referred to above.

We are also concerned with further potential complexity for employers in relation to proposals by the Australian Industrial Relations Commission to specify default funds in various "modern" industrial awards.

2.2. Coverage not wide enough

2.2.1. Mercer Submission to the Harmer Pension Review

We recently lodged a submission to the Harmer Pension Review which included recommendations to improve the adequacy of the SG system by widening its coverage to include many of those currently excluded. This is attached as Appendix 1.

2.2.2. Recommendations

Our recommendations were to:

1. Gradually phase the self-employed into the Superannuation Guarantee system. A possible implementation programme would be to commence from, say 1 July 2010 at a 3% level. The contribution level would then increase by 1% every second year, reaching 9% from 1 July 2022.

2. Expanding the Superannuation Guarantee system to cover workers compensation benefits and paid parental leave. It would appear reasonable that employers should take responsibility for continuing retirement provision for those who were injured or became ill due to workplace incidents and are covered by workers' compensation. We suggested a deferment of SG requirements for those on parental leave until paid leave becomes more common or more widely mandated as otherwise it would act a as a discouragement to employers providing such leave. Since lodging our submission to the Harmer Review, we note that the Productivity Commission has tabled its proposals for parental leave which also include employer financed superannuation arrangements.

3. Providing some form of additional Government assistance to the long term unemployed, disabled and carers (ie carers of young children, the sick and the aged) to make up for part of the Superannuation Guarantee these Australians do not receive.

2.2.3. Low Paid Workers

Another group of employees who are excluded from the SG system are those who earn less than $450 a month. Whilst we understand that these employees were initially excluded due to the concerns about administration, we note that the $450 a month limit has not varied in 16 years.

Whilst there were logical reasons for this exemption in 1992, the lack of indexation since then has resulted in a significant reduction in the number of cases where the exemption applies. In today's environment, with the expansion of e-commerce, the introduction of Choice of Fund and the fact that virtually all workers now have a superannuation fund that can be used, we consider that there is no longer a need for such an exemption.

We note that those most likely to not have a superannuation fund would be part-time workers under age 18. These workers would generally be covered by another existing exemption and the removal of the exemption for those earning less than $450 a month would not affect this younger age group.

2.2.4. Recommendation

We recommend that the exemption for those earning less than $450 a month be removed.

2.3. Too complex for employers

Significant complexities relate to:

1. The definition of Ordinary Time Earnings (OTE);

2. The payment of contributions (particularly relating to problems resulting from Choice of Fund);

3. The reporting requirements where an employer has discovered that underpayments have occurred.

2.3.1. Ordinary Time Earnings

The definition of OTE is too vague. Whilst the inclusion of normal salary and wages is obvious, there are many other types of payment where there is often doubt over whether they should be included or excluded from OTE. Doubt most often arises in relation to payments such as regular overtime, payments for working at night or on weekends and various allowances.

Whilst the ATO has issued a Superannuation Guarantee Ruling in relation to this, the Ruling is not comprehensive and many doubts remain. To resolve these doubts, many employers seek legal advice to assist in coming to a conclusion. However, even this does not provide full protection as the ATO could dispute any conclusion adopted by the employer.

This complexity is highlighted by the following examples:

- the recent issue of a 39 page draft ruling in respect of payments in relation to sportspersons (SGR 2008/D1); and

- a court case in 2003 (Australian Communication Exchange Ltd v Deputy Commissioner of Taxation) where different decisions were made in three tiers of the court system and finally ending as a split decision in the High Court.

Simplification of the definition is very desirable. However any simplification could result in either higher costs to many employers or lower contributions for many employees.

One option would be to include all payments other than fringe benefits, superannuation contributions and reimbursements of expenses. This would include overtime. A considerable implementation period would also be necessary for employers to change systems and budget for any changes.

Such a change should be considered instead of any increase in the current 9% contribution rate.

2.3.2. Recommendation

Greater clarification of OTE should be included in the legislation. In the longer term, the definition should be extended to include all payments other than fringe benefits, superannuation contributions and expense reimbursements (instead of any increase in the 9% employer contribution rate).

2.3.3. Payment of contributions

Contributions must be received by the relevant fund by the 28th day following the end of each quarter. Whilst this should be reasonably straight forward if an employer is only contributing to one fund, it is more complex if contributions are being paid to more than one fund. Many employers, particularly larger employers, are utilising "clearing houses" to pass their contributions on to the various funds.

We support the Government's intention to introduce a clearing house which may be more readily available to all employers.

However, payment of the SG contributions to a clearing house within 28 days of the end of the quarter does not satisfy the SG requirements. Rather, the clearing house must first clear the employer payment and pass it on to the relevant fund before the 28th day. This process can often take a week or more whilst the clearing house waits for clearance of the payment and is largely outside the employer's control.

2.3.4. Recommendation

Payment to an approved clearing house by the 28th day after the end of the quarter should be considered as satisfying the SG requirements.

If such a recommendation is adopted, then it may be necessary to place limits on how long a clearing house can retain the contributions.

2.3.5. SG Statements

When an employer realises that an SG contribution has been underpaid, it is necessary to complete an SG Statement and lodge this with the ATO. In many cases, the underpayments are accidental, either resulting from a payroll error or because the employer was unaware that certain payments were included in OTE.

It is possible that these errors could have been occurring for a number of years for a large number of employees.

The SG Statements must however be completed separately for each quarter and can require considerable repetition of data.

We note that the "calculator" available on the ATO website to assist employers in lodging these returns indicates that it will take an employer approximately 5 to 10 minutes for each employee for each quarter. For example, if an employer inadvertently omits to pay superannuation on a specified allowance of $10 a week for 100 employees over a year, then, assuming an average completion time of 7 minutes per employee per quarter, this would take around 2.5 man weeks just to complete the ATO forms online assuming that all data required on the forms was readily accessible – just to fix an administrative error with an impact of less than $50 per employee.

We expect that the costs of reporting errors and the associated penalties are so onerous that there is considerable incentive for employers to ignore small errors and hope that they are not picked up in a subsequent audit.

We believe that the time taken to complete such statements could be considerably reduced to allow statements to be made for a particular employee covering more than one quarter.

2.3.6. Recommendation

SG Statements should be redesigned by the ATO to reduce the time taken for completion by employers. If necessary, the legislation should be amended.

2.4. Penalties are too severe

2.4.1. Current Penalties

There are multiple penalties relating to the underpayment of SG contributions. These include:

- the loss of tax deductibility on the eventual payment;
- a minimum SG charge of $20 per affected employee per quarter;
- an administration fee of $20 for each employee for each quarter affected;
- an interest payment of 10% pa applicable from the start of the relevant quarter (ie approximately 4 months earlier than when the contributions should have been paid). (The General Interest Charge applies from the time the SG Statement is lodged.);
- the requirement that the underpayment be based on the employee's "salary and wages" rather than OTE. "Salary and wages" can be considerably greater than OTE because it includes items such as overtime and certain termination payments;
- various penalties for late lodgement, providing false information, trying to hide errors, not providing information on request etc.

Recent changes which removed a "double payment penalty" where contributions were paid late have been welcome but have not gone far enough in respect of employers who make honest mistakes or where there are minor and infrequent delays in payment.

Because of the penalties and the administrative burdens of completing the paperwork, we suspect that some employers decide not to declare underpayments. Rather they are totally swept under the carpet or the necessary contributions are paid late but the breach is not declared to the ATO.

We note that in the example set out above the administration fee alone exceeds the quarterly shortfall.

2.4.2. Recommendations

Consideration should be given to:

- Basing the SG Charge (payable when the appropriate contributions have not been paid to a superannuation fund) on OTE rather than salary and wages.

- Enabling employers to make an additional payment directly to the superannuation fund equating to late payment interest on any late contribution rather than paying this to the ATO.

- Allowing late payments to a superannuation fund to be tax deductible where an appropriate late payment interest adjustment has been paid.

- Removing the need of an employer to lodge an SG Statement with the ATO, subject to making the appropriate payment and interest to the fund within 12 months of the end of the relevant quarter.

2.5. International workers

2.5.1. Bilateral agreements

Australia has now established bilateral Social Security agreements with Belgium, Chile, Croatia, Germany, Greece, Ireland, Korea, Norway, Portugal, Switzerland, The Netherlands, and the United States of America. For employees who are transferred overseas, these agreements provide some level of protection for employers from requirements to pay SG or similar contributions in both countries for the same work.

However we believe that these agreements do not go far enough and leave considerable gaps for Australians who are transferred overseas.

These agreements only provide exemptions where there are requirements for the employer to contribute under both Australian law and the law of the overseas country.

This works satisfactorily where an Australian company transfers an employee to work in one of the countries listed above provided that the employee continues to work for the Australian company AND remains a resident of Australia as the SG requirements continue to apply in these circumstances.

However there is no requirement for an employer who is not a resident of Australia to make SG contributions. Thus, if an employee is transferred overseas on a temporary basis but is employed by say the Australian company's overseas parent, there are no SG requirements and hence the bilateral agreement does not apply – even if there are arrangements in place for the Australian company to continue to contribute for the employee whilst overseas.

Similarly, there is no requirement for an Australian resident employer to make contributions for a person who is no longer an Australian resident in respect of work performed overseas and hence the bilateral agreement does not apply when Australian residency ceases.

2.5.2. Recommendation

The Government should attempt to broaden the scope of future bilateral agreements (and renegotiate existing agreements on similar lines) to at least provide an exemption from overseas requirements where an Australian resident is transferred by an Australian employer to a related company overseas.

2.5.3. Short-term visitors

Senior executives of many international companies often travel to Australia to visit their Australian operations. These executives are employed by their overseas employer who is technically required to make SG contributions for the executive in respect of work performed in Australia. Whilst there are some exemptions, these exemptions are limited to specified visas **and** specified roles.

Similar issues also apply where other senior or middle level overseas employees are sent to Australia briefly to ascertain what is happening in the Australian operation.

Whilst exemptions would normally be available under the bilateral agreement route where the employees are visiting from the countries listed above, it would generally be necessary for the overseas employer to obtain a certificate of coverage from their local authorities creating further administration and paperwork.

We consider that automatic exemptions should apply in respect of these short term visits. A limit of, say 4 weeks "work" could be attached to such an exemption.

2.5.4. Recommendation

Exemptions from SG for short term "visits" by overseas executives and other employees should be extended subject to working no more than four weeks in Australia on any trip.

2.5.5. Temporary Residents

Currently, when a temporary resident leaves Australia, the employee can normally cash their superannuation benefit (Departing Australia Superannuation Payment) with a special tax rate of 30% applying to the taxed element of the taxable component of the benefit. (Higher rates apply to any untaxed element.) Alternatively, the benefit can be retained in the Australian superannuation system and eventually paid on retirement where normal Australian tax rates apply.

The Government has proposed that the 30% rate be increased to 35% as part of the Temporary Residents' Superannuation Legislation Amendment Bill 2008 and the Superannuation (Departing Australia Superannuation Payments Tax) Amendment Bill 2008 Bill 2008. The combination of this tax together with the 15% contribution tax makes compulsory Superannuation Guarantee savings for temporary residents (along with other non-compulsory contributions) ineffective from a tax point of view (except, perhaps for some of those who are on the top marginal tax rate).

The position is worsened if consideration is given to any tax that may be payable by the temporary resident in their home country. We note that Australia's double tax agreements with other countries do not generally cover lump sum superannuation benefits with the result that tax may be payable in both Australia and the employee's home country.

Significantly higher tax will be payable in respect of SG contributions than if these had actually been paid as salary.

Further concerns apply in respect of those who do not take their benefit within 6 months of leaving Australia if the above Bill is passed. It will be necessary for superannuation funds to transfer any benefits remaining unclaimed after about 6 months to the ATO as unclaimed monies. Whilst it can be claimed at any time, no interest will be paid by the ATO and any continuing insurance cover will be lost.

We have raised these concerns with the Senate Economics Committee in our submission dated 13 October 2008.

Further, these changes are likely to make it more difficult for employers to solve skills shortages by attracting skilled staff from overseas, including transfers from associated companies overseas.

2.5.6. Recommendation

The changes in the Temporary Residents' Superannuation Legislation Amendment Bill 2008 and the Superannuation (Departing Australia Superannuation Payments Tax) Amendment Bill 2008 should be reconsidered.

To avoid adverse retrospective tax changes, if the new rules proceed, they should only apply to temporary residents arriving in Australia after the Bill receives Royal Assent.

2.6. Modern Awards

2.6.1. Proposals by Australian Industrial Relations Commission

The Commissioner is currently proposing that default superannuation funds will be included in modern awards.

This could have significant adverse implications for provision of Superannuation Guarantee benefits.

In summary our main concerns include:

- The apparent anti-competitive nature of the provisions. There is the potential for a significant reduction in competition as many funds, unless they can be included as a default fund, may be unable to remain in business. This will ultimately be to the detriment of employees as the fall-out from such a situation is likely to be higher fees.

- The potential loss of valuable benefits provided by the current default fund which cannot (or will not) be replicated in any default fund named in the relevant award.

- Significant disruption for employers and employees where the new provisions override existing default fund arrangements.

- Additional compliance costs by employers particularly those with employees covered by a range of awards with potentially each award specifying a different default fund.

More detail can be found in Mercer's submission to the Australian Industrial Relations Commission dated 10 October 2008.

2.6.2. Recommendation

Consideration should be given to removing the ability for default funds to be specified in industrial awards.

3

CONTRIBUTION TAXES AND INCENTIVES

3.1. Introduction

Superannuation provides two major components of our retirement system – the compulsory SG system (second pillar) and voluntary contributions (third pillar). These two pillars support the safety net age pension (first pillar).

However, long term saving which is locked in by preservation requirements is not an attractive investment for many income earners, given their natural focus on short and medium term needs. Hence, for many years, Australian Governments have provided encouragement and financial incentives to save through superannuation arrangements.

Further, in order to contain Government costs in relation to the provision of future age pensions, there must be seen to be appropriate Government support and encouragement of superannuation through the second and third pillars.

3.2. Current disincentives

Government support and encouragement for saving through superannuation is particularly necessary to offset some significant disincentives which include:

- benefits are subject to preservation and generally cannot be accessed until retirement except in specified circumstances;
- benefits are subject to tax if taken before age 60;
- higher savings will reduce the ability to claim the age pension;
- significant additional tax applies to contributions (both pre-tax and after-tax contributions) in excess of specified limits;
- a legislative risk – ie there is no guarantee that a Government will not change the rules adversely in the future;
- exposure to market risks and longevity risks by individuals.

Despite acting as disincentives, the first two items are critical pieces of the system in that they encourage superannuation savings to be retained until retirement. The third is also critical in that it contains Government costs whilst the fourth limits the benefits that the rich can obtain from the system and was introduced as part of the Simpler Super changes to compensate for the removal of the complex Reasonable Benefit Limit system.

On the other hand, the legislative risk is likely to be a risk in any system and there is little that can be done to remove it.

3.3. Current incentives

In view of the previous comments, it is important to consider the adequacy of the current incentives which include:

- pre-tax contributions are taxed at 15% rather than marginal tax rates;
- investment income is taxed at 15% rather than marginal tax rates (no tax on investment income whilst in the pension phase);
- contributions made by the self-employed are generally tax deductible;
- a means tested Government co-contribution in respect of after tax contributions;
- a means tested rebate on contributions made by an eligible spouse;
- no tax on most benefits after age 60 (however benefits have already effectively been subject to 15% tax due to the tax on contributions and investment income);
- no investment tax in pension draw down phase.

It is also important to acknowledge that incentives are important for compulsory as well as voluntary contributions. If compulsory contributions are not "encouraged" this could lead to a general negative perception about superannuation which would result in a discouragement for all contributions.

It is also worth noting that distinguishing between voluntary and compulsory contributions would be very difficult, if not impossible for employers and superannuation funds. Hence the provision of different levels of incentive between Superannuation Guarantee and voluntary contributions would be extremely complex and introduce another level of inequity.

3.4. Current concerns

Some of the major issues that currently apply to the superannuation incentives are:

- greater incentives are provided in respect of higher income earners whilst there are very limited or no incentives for lower income workers;

- the income testing of the Government co-contribution effectively represents an additional marginal tax rate (for those who are able to save through superannuation) of 5% for those with incomes between $34,032 and $60,342 (the income range over which the co-contribution phases out);

- workers need to determine whether after tax or pre-tax contributions are more tax effective which can be difficult to ascertain without paying for tax advice;

- couples need to determine whether it is more tax effective for:
  - the low income partner to make personal contributions and, if eligible, qualify for the Government co-contribution; or
  - for the spouse to make an eligible spouse contribution and possibly qualify for the eligible spouse contribution tax offset; or
  - for the higher income spouse to make additional contributions for their own superannuation from after tax salary and potentially qualify for the co-contribution; or
  - for the higher income spouse to make additional contributions for their own superannuation through salary sacrifice.

In short, the contribution system is not simple and does not encourage appropriate behaviour for many Australians.

3.5. Consideration of incentives

The next three sub-sections consider the value of incentives for individuals with different marginal tax rates.

3.5.1. Those on marginal tax rates of 40% and above

This section considers those with a taxable income of $80,000 to $180,000 (marginal tax rate of 40% and those with a taxable income in excess of $180,000 (marginal tax rate of 45%). The major concession for this group is the 15% tax rate on pre-tax contributions. This group can generally arrange for any voluntary contributions to be paid on a salary sacrifice basis. The major disincentives are preservation, the likely inability to claim the means tested age pension and the legislative risk.

Overall, we consider that there is a broad balance between the incentives and disincentives and that there is still sufficient incentive to save through voluntary superannuation contributions as well as SG contributions.

3.5.2. Those on a marginal tax rate of 30%

This section considers those with a taxable income of $34,000 to $80,000. Whilst the nominal marginal tax rate is 30%, the average tax rate will be significantly below this and, at the lower end of this income range may be less than 15%.

For this group there are two primary incentives – the 15% tax rate on pre-tax contributions and investment income and, for some, the Government co-contribution. Again, subject to the agreement of employers and sufficient flexibility in Awards, voluntary contributions by salary sacrifice can generally be arranged.

The major disincentives are preservation and the likelihood, that, at least for the younger generation who will be in the SG system for the majority of their working life time, the potential loss of part of the age pension which could inhibit voluntary contributions.

For this group, the adequacy of the incentives for voluntary contributions must be questioned.

For those whose taxable income together with reportable fringe benefits exceeds $60,342, the Government co-contribution no longer applies. Thus the co-contribution is not an incentive at this income level. In fact, in some cases, it could be a disincentive as the person could contribute on the basis that a co-contribution will apply, but because of unexpected income, such as overtime, the person is surprised that no co-contribution is payable.

In any event, as indicated above, for those who are making after-tax contributions, the phase out of the co-contribution from $1,500 to $0 over a $30,000 income range represents a 5% effective marginal tax rate. We consider that this is too high and should be reduced by extending the phase-out period, in particular by raising the upper threshold to at least the level at which the 40% marginal tax rate applies. We note that those at the lower end of this income range are also subject to a further effective marginal tax of 4% due to the phasing out of the Low Income tax offset and another 20% due to the phasing out of Family Tax Benefit A.

Further complexities arise for those in this income bracket who wish to make voluntary contributions in relation to whether it is better to contribute on:

- a pre-tax basis – in other words making salary sacrifice contributions with a potential saving of 15% plus Medicare (ie the saving in marginal tax of 30% offset by the 15% superannuation contribution tax); or

- a post-tax basis with a potential Government co-contribution ranging from 150% to 0% of the contribution.

The difficulty is compounded by the fact that workers will often not know what their earnings will be for the full year and the level of the co-contribution that might be available. We consider this further below under the heading "Simplification of contribution types".

3.5.3. Those on marginal tax rates of less than 30%

This section considers those with earnings up to $34,000 where the marginal tax rate is either 0% or 15%.

Higher effective marginal tax rates may apply due to the phase out of the Low Income tax offset (4% from $30,000) and Family Tax Benefit Part A or Part B (20% with income level depending on type of benefit claimed and, for Part A, the partner's income).

In the following sections we consider the treatment of the various types of contributions for those in this income range.

Employer contributions

For most of this group (particularly those who do not qualify for Family Tax Benefits), there is no incentive for SG contributions or for voluntary pre-tax contributions. The 15% contribution tax is significantly higher than the effective tax rate (allowing for the low income tax offset) applicable to taxable income.

It would be extremely difficult, if not impossible, to apply differential contribution tax rates within a superannuation fund. (The superannuation surcharge which was introduced in 1996 attempted to achieve differential rates however the administration of the surcharge created huge difficulties and high administration costs for superannuation funds and the ATO. Many of these difficulties had not been overcome by the time the surcharge was abolished in 2005. It also resulted in considerable inequities for those whose earnings fluctuated significantly for year to year. The surcharge provided a valuable lesson on the problems of variable rate taxes in a superannuation fund.) It is therefore critical that any attempt to fix the lack of incentive for low income earners is achieved outside the superannuation fund although an approach similar to the current Government co-contribution would be feasible.

Any adjustment should at least result in the refunding of all contribution tax for those who earn less than say $16,000. (Individuals earning less than $16,000 will pay no tax from 1 July 2010 based on the proposed increases to the low income tax offset.)

However we would prefer to see the adjustment applying to those earning slightly more than this amount.

We suggest a maximum adjustment of $350 (which represents 15% of SG contributions for a person earning just under $26,000). The adjustment could then be phased out over an income range of $26,000 to $30,000. (Whilst a longer phase out would be desirable, if it continues to phase out passed $30,000, then this would overlay with the phase out of the low income tax offset which commences phasing out at $30,000.)

Two approaches which would be reasonably efficient would be:

1. To pay the adjustment as a further Government co-contribution; or
2. To provide the adjustment as a refundable tax offset directly to the individual.

After-tax contributions

The above comments relate to employer contributions. It is also necessary to consider after tax contributions.

Whilst the Government co-contribution is available, at the maximum or close to the maximum rate for this income group, this group has little ability to save (unless the contributions are financed via a gift from, say, the person's spouse).

Further, the co-contribution is only payable if the person has earned at least 10% of their income from employment or running a business. This can result in the absurd situation where a 15 year old with limited investment income can earn $50 from a paper round, contribute $1,000 to super (basically a gift from the parents) and claim a $1,500 co-contribution.

On the other hand, a "non-working" mother who has withdrawn from the workforce to look after her children, and has earned a small amount of investment income is not entitled to a co-contribution if she contributes some of her investment earnings or savings to superannuation.

3.5.4. Recommendation - Government co-contributions

The upper income threshold to which the co-contribution applies should be increased to $80,000 ie the level at which the 40% marginal tax rate cuts in.

Eligibility for co-contributions should be extended to those who earn less than 10% of their income from employment or business activity. To avoid abuse, the work test could be retained for those below age 18 and those who have reached age pension age.

3.5.5. Recommendation – Low income earners

To boost the superannuation incentives for low income earners, a refundable tax offset (or additional Government contribution to superannuation) of 15% should be applied to any concessional contributions. The rebate would be capped at say $350 and phase out between income ranges of $26,000 and $30,000.

3.6. Simplification of contribution types

3.6.1. Some contributions are not tax deductible, others are either deductible or equivalent to deductible

The self-employed and substantially self-employed are able to claim a tax deduction for any contributions made.

Employed persons are not able to claim a tax deduction for voluntary contributions although most highly paid employees can generally arrange to make voluntary contributions on a salary sacrifice basis. This has a similar effect to being able to claim a deduction.

However many lower and middle income employees may not be able to salary sacrifice because their employer does not allow it. This could be because the employer does not have the administrative capability, does not understand the processes or salary sacrifice may not be allowed under the industrial award that covers the employee.

Whilst generally, contributing by salary sacrifice is more beneficial to the employee than after tax contributions, this may not be the case where eligibility for the co-contribution is possible.

Thus for incomes below about $60,000, an employee must consider the relative advantages of contributing by salary sacrifice or from after tax income. In many cases the answer may be a combination of after tax and salary sacrifice contributions which adds further to the complexity of superannuation.

Significant simplification could be achieved if a tax deduction was available for after-tax contributions. This would have little impact on high income earners (as any voluntary contributions would already be made by salary sacrifice – at least up to the concessional contribution cap). Rather, it would assist low to middle income earners who currently cannot contribute by salary sacrifice (or do not understand the advantages).

3.6.2. Contribution tax

Currently, contributions are either:

- not subject to contribution tax (after tax contributions by a member, contributions by an eligible spouse and certain contributions for children under age 18); or
- subject to 15% contribution tax (employer contributions, salary sacrifice contributions, contributions for which a tax deduction is claimed (self-employed and substantially self-employed only) and contributions by other individuals).

If all contributions were tax deductible, then all contributions would be subject to the 15% contribution tax.

3.6.3. Other issues

To avoid abuse, it may be necessary to place a cap on the level of member contributions which would be treated as tax deductible.

3.6.4. Advantages of treating all personal contributions as tax deductible

This would provide significant simplification, ie it would

- simplify the explanation and calculation of contribution tax
- simplify decision making for low to middle-income earners as decisions would not be necessary as to the advantages of contributing by salary sacrifice or from after tax earnings
- remove some of the administrative difficulties for superannuation funds and the self-employed relating to the requirements for claiming a tax deduction
- remove issues arising from re-contribution strategies where benefits are cashed and then re-contributed to superannuation to obtain subsequent tax advantages
- remove a disadvantage of superannuation compared to other investments for which a tax deduction might be claimed (eg negative gearing)
- simplify the payment of benefits and calculation of tax on benefits (although there would be a long period whilst the previous contributions worked their way out of the system).

3.6.5. Recommendation - deductibility of contributions

Consideration should be given to treating after-tax contributions as tax deductible (with appropriate limits) in order to simplify the system and create greater equity.

A special adjustment would be necessary for low income earners to ensure that they obtain an appropriate benefit to at least offset the contribution tax payable.

3.7. Review of provisions no longer necessary

3.7.1. Introduction

Many superannuation provisions have been introduced on a piecemeal basis over the years. In many cases, the need for the provisions no longer exists.

3.7.2. Eligible spouse contributions

Eligible spouse contributions were introduced when contributions by those not in the workforce were not allowed. This was one means of enabling couples to provide some level of superannuation for a non-working spouse. Normally the working spouse would contribute on behalf of their non-working partner. A small rebate was available to the spouse who made the contribution on behalf of their partner.

Since that time, changes to contribution recommendations allow any person up to the age of 65 to contribute to their own superannuation and co-contributions have been introduced.

3.7.3. Child contributions

Similarly, provision was made for child contributions when non-working children were unable to contribute to superannuation. These provisions enabled parents, grandparents and others to contribute for the child. However they proved very unpopular with almost zero take-up.

With the changes in the regulations about who can make a contribution, the need for these provisions disappeared. The parent or grandparent can now give the child the money to make a contribution on their own behalf. Subject to meeting the 10% employment test, the child might also be able to claim a co-contribution.

3.7.4. Recommendations

In order to simplify the system, consideration should be given to removing provisions such as eligible spouse contributions and child contributions

4

SUPERANNUATION DEATH BENEFITS

4.1. Introduction

The current method of taxing superannuation death benefits adds significant complexity to the superannuation system and can often result in considerable inequity.

4.2. History

To help explain the issues involved, a brief outline of the history of the tax may be of value.

1983 - Tax on superannuation benefits was introduced with a tax rate of 30% (reduced to 15% on the first $50,000 if over age 55). However death benefits paid to the deceased's spouse, children under 18 and financial dependants were exempt from the new tax.

1988 – Tax on contributions was introduced at a rate of 15%. As broad compensation, tax on benefits was reduced by 15%. This created some complications in respect of death benefits:

- Where a lump sum death benefit was paid to the deceased's spouse, a child under age 18 or a financial dependant, it was not possible to reduce the then current tax rate by 15% as these benefits were already tax free.
- In order to obtain the passage of the legislation in the Senate, the Government agreed to provide an "anti-detriment" tax deduction to a superannuation fund if it augmented the death benefit to what it would have been if the contribution tax had not been introduced. This tax deduction only applied where the benefit was payable to the spouse, former spouse, child of any age or financial dependant.
- Where a death benefit was payable to a person other than the deceased's spouse, a child under 18 or a financial dependant, the tax rate on part of the benefit was reduced by 15% however no reduction applied to the notional insured portion of the benefit resulting in part of the benefit being taxed at 15% and part at 30%.

2004 – Death benefits payable to those in an interdependent relationship with the deceased became tax free (but the anti-detriment provisions did not automatically flow through to these members).

2007 – The Simpler Super changes were introduced which included

- a removal of tax on all benefits paid directly to the member became tax free from age 60;
- death benefits payable to the spouse, children (under 18), financial dependants and those in an interdependent relationship remained tax free with tax continuing to apply where the benefit was paid to other beneficiaries, even where the member was over age 60;
- the anti-detriment provisions were restricted to payments made to the member's spouse, former spouse or child of any age. It is no longer available where the benefit is paid to other financial dependants or interdependants.

2007 – Benefits payable to those with a terminal medical condition became tax free.

4.3. Summary of current system

4.3.1. Tax payable

The tax payable on superannuation death benefits is very complex with the following complications:

- Some death benefits are tax free – others are subject to tax;
- Where subject to tax, the taxable component can be taxed at 15% or a combination of 15% and 30%;
- The portion taxed at 30% is based on a proportion of the death benefit based on the person's period of past eligible service and the period to retirement. It can result in significant inequities ;
- Retirees who obtain appropriate financial advice can utilise re-contribution strategies which remove the potential for tax on future death benefits.

The following examples highlight these issues:

Example 1

Members A, B, C and D retire at age 63 with benefits of $410,000 each. In each case, the benefits relate totally to employer contributions and there is no pre-July 1983 component. The benefits are taken in the form of an account-based pension. Several years later, each member's account balance is $400,000 when they are each diagnosed with terminal cancer. Shortly afterwards each member dies.

Member A had a spouse and the trustee of the fund decided to pay the remaining account balance as a lump sum. The lump sum death benefit payment is not subject to tax.

Members B, C and D no longer have a spouse but each has 2 adult children who are not financially dependent on the member.

Member B was still receiving his account-based pension when he died and tax of $60,000 (ie 15% of $400,000) was payable on the death benefits when distributed to the member's children as the children were not financially dependent.

Member C had arranged for his daughter to have an enduring power of attorney and a week before his death the daughter had arranged, on his behalf, for the member's fund to cash his entire benefit. No tax was applied to the benefit which was subsequently distributed through the member's estate to his children.

Member D had also arranged for his daughter to have an enduring power of attorney and again, a week before his death the daughter applied, on his behalf, to cash his entire benefit. In this case, the fund took longer to pay the benefit as it needed to verify the power of attorney arrangements and the benefit had not been paid by the time the member died. The fund subsequently paid the benefit, less $60,000 tax to the member's children.

(For simplicity, we have ignored the Medicare levy in this example.)

The difference between the outcomes for members C and D in example 1 highlights that timing is critical. A benefit which is not subject to any tax if paid to the member can become subject to tax if payment is deferred until after death. The anomalies are obvious. Furthermore, superannuation funds, through no fault of their own, are likely to be caught up in taxation disputes at the time of death benefit payments.

<u>Example 2</u>

Member E also becomes entitled to a benefit of $410,000 at age 63 however, following financial advice he cashes his entire benefit (no tax applies as he is over age 60) and then re-contributes the amount to commence an account-based pension.

When member E dies several years later his lump sum death benefit will be totally tax free. It will not matter whether the benefit is paid to his spouse, adult children or whether or not it is cashed before he dies.

Example 2 highlights the importance of obtaining financial advice. It also emphasises that the tax treatment of death benefits is likely to lead to what might be considered to be "inappropriate" behaviour in order to minimise the potential tax on future death benefits. Existing pensioners, particularly those under age 60 and those approaching retirement will need to consider this opportunity to significantly reduce or remove the potential death benefit tax.

<u>Example 3</u>

Members F, G, and H are each aged 35 and are working for the same employer. Each has a death benefit of $90,000 made up of a $40,000 account balance and $50,000 insurance. None of the members have any dependants when they are killed in a car accident. In each case, the insurance is provided through the employer's default fund. Their friend, J, also 35 and a 10 year employee, was fatally injured in the accident and had a similar benefit. He survived long enough to be able to cash his benefit under the terminal medical condition provisions which enabled him to receive the whole benefit tax free just before he died.

Members F, G and J have been working with the same employer for 10 years. H has only recently joined the employer after being with his only previous employer for 10 years.

Member F has an account balance of $40,000 in the default fund.
Member G had recently transferred her account balance of $40,000 to another fund, Fund 2, but has no insurance in that fund.
Member H has recently joined the default fund but had not yet transferred his $40,000 account balance which is currently sitting in Fund 3.

Despite the members each being the same age and having the same account balance and insurance levels, the tax payable can be considerably different:

Tax on member F's benefit: $23,625
Tax on member G's benefit: $19,125
Tax on member H's benefit: $21,000
Tax on member J's benefit: nil

Example 3 highlights inequities in which substantially different levels of tax can apply to similar benefits.

4.3.2. Anti-detriment payments

Whilst well intended, the anti-detriment system has not satisfactorily met the original intentions of the Parliament.

For example, an anti-detriment payment is only paid to death benefit beneficiaries at the discretion of the trustee of the superannuation fund. It is not paid in all cases.

- It is virtually impossible for a self-managed superannuation fund to make an anti-detriment payment because it has no assets that it can call on to pay the beneficiary. Whilst the cost of the anti-detriment payment would be offset by a tax deduction, the offsetting tax deduction is only payable if the benefit has already been paid. This is not possible if there are no assets to pay the benefit.

- Larger superannuation funds also have difficulties, particularly where there are no reserves or where the fund is in a tax loss position and any benefit from the available tax deduction will not be available for, at best, many years. Similar issues apply in relation to funds that are winding up where it might never be possible to utilise the value of the tax deduction.

- Where the benefit is payable to the deceased's estate, the administrative costs of determining the eventual recipient of the benefit may not be insignificant and there may be a continuing doubt as to who the eventual recipient will be. (If an anti-detriment payment is made to the estate on the expectation of it being paid to a child of the deceased but subsequently the estate pays the proceeds to another person, the fund's expected tax deduction may not eventuate.)

Further, the availability of the anti-detriment tax deductions were not passed on to cases where the benefit is paid to a person in an interdependent relationship with the deceased and were removed from cases where the benefit is paid to a financial dependant. The treatment of interdependent and financially dependent relationships is inconsistent with the original intention of the legislation.

The introduction of tax free payments to those who are suffering from a terminal medical condition has created further inequities. Those who are desperate to receive their benefit before death, often to pay for expensive medical treatment, may not realise that the benefit they might receive will not include the anti-detriment amount which would have applied if the benefit had not been paid until after death.

4.3.3. Summary

In our view, the tax treatment of death benefits is not appropriate for a simplified and equitable superannuation system and many anomalies apply. Those who are willing to pay for financial advice will often be able to manipulate their arrangements to avoid the tax. In other cases, financial advice will need to be obtained to avoid potential pitfalls.

Likewise the anti-detriment provisions are inappropriate in that are not universally available and do not meet their original intention.

4.3.4. Recommendations

Consideration should be given to removing the tax on all lump sum superannuation death benefits. This is particularly important where the deceased is over age 60.

The anti-detriment provisions should also be reviewed with consideration given to either:

- repealing the provisions with the savings used to finance the removal of tax on all death benefits; or
- modifying the provisions to enable anti-detriment provisions to be utilised by all funds and extended to apply to those who are financially dependent on or in an interdependency relationship with the deceased.

4.4. Treatment of death benefits paid by employers on the death of an employee

4.4.1. Under-insurance

Australia faces the following challenge:

- Many working Australians are under-insured. As a result in the event of their death, their dependants may face hardship and require assistance from the government or from the employee's employer

Employers are well-positioned to provide death benefits to employees, and many have done so for many years. Employers can purchase insurance on a group basis which generally means that premium rates are lower than when an individual purchases their own retail policy and often employees can be provided with cover without the need to fill in forms or provide medical evidence.

4.4.2. Concerns with current system

Under the current system it is difficult for the employer to provide death benefits in a tax-effective manner.

In the past (prior to the introduction of Choice of Fund) these benefits were often provided via the employer's superannuation fund. However with the introduction of Choice of Fund legislation generally only those employees who participate in the employer's default superannuation fund can benefit from such support. Some employers provide insurance benefits by purchasing a group insurance policy. However from 1 July 2007 the taxation of benefits payable under an employer-owned group life policy changed. As a result, many beneficiaries will receive a lower after-tax payment than would have been the case had they claimed a benefit before 30 June 2007 or had the benefit been paid from a superannuation fund.

A further problem is that benefits can be taxed more heavily if the benefits are paid via the employee's estate rather than directly to employees. In most cases, we would expect that employers will pay any death benefit to the deceased employee's estate. However, under the current rules, this is likely to be the option which results in the highest amount of tax. We consider that this outcome is unreasonable. Many employers would feel responsible to ensure that the benefit is paid tax effectively and such major discrepancies are therefore likely to require employers to incur additional costs to ensure that death payments are made in an effective manner.

Our recommendation is to treat the taxation of death benefits paid by an employer, in the same manner as benefits paid from a superannuation fund and to treat benefits paid to dependants, via an estate, in the same manner as benefits paid directly to the dependant. The taxation revenue loss is expected to be low. The removal of this major disincentive for employers to provide such benefits could result in higher life insurance coverage of the working population.

4.4.3. Summary of current taxation of lump sum death benefits

The following table highlights some of the inconsistencies and inequities in the current arrangements:

Benefit payable to	**Payable from superannuation fund**	**Payable by employer**
Dependant	0%	First $145,000 of the ETP (for each payee) is tax free. Balance taxed at highest marginal tax rate (currently 45%).
Non-dependant	Taxed element taxed at 15%. Untaxed element (proportion of the benefit where deduction claimed for insurance premiums) taxed at 30%.	The first $145,000 of the ETP (for each payee) is taxed at 30%. Balance taxed at highest marginal tax rate (currently 45%).
Estate (Generally no tax is withheld at the time the benefit is paid to the Estate.) The Legal Personal Representative (LPR) will calculate tax at the appropriate rate depending on who the Estate is distributed to.	LPR withholds tax at the above rates depending on whether benefit is paid to a dependant or non-dependant.	LPR withholds tax at the above rates according to whether the beneficiaries are dependants or non-dependants, however only $145,000 of the total benefits payable to dependants and $145,000 of the total paid to non-dependants is taxed at the lower rates.

Medicare levy is generally payable in addition to the above taxes

The following example illustrates some of the issues:

(For simplicity we have ignored the Medicare levy in this example.)

A death benefit of $1 million payable by an employer (all taxable component) is paid to the estate of a deceased employee. The employee's will specifies that the estate be distributed in 5 equal portions to the employee's wife and 4 children so each would be entitled to a $200,000 share.

Child D is still a dependant however children A, B and C are adults and no longer financially dependant on the deceased.

Of the death benefit $400,000 will be paid to dependants. The first $145,000 of this will be tax free and 45% tax will apply to the balance (i.e. tax of $114,750).

$600,000 will be paid to non-dependants and tax of 30% will apply to the first $145,000 of this and tax of 45% of the balance (i.e. tax of $248,250).

The total tax payable by the estate will therefore be $363,000.

If the employer had paid $200,000 to each of these beneficiaries directly, rather than to the estate, each of the two dependants would have been liable for tax of $24,750 (being no tax on the first $145,000 and 45% on the balance), and the three non-dependants would have been liable for tax of $68,250 (being 30% tax on the first $145,000 and 45% of the balance). The total tax payable would have been $254,250.

In this example, by paying the benefit to the employee's beneficiaries directly, rather than the estate, the total tax on the benefit has decreased from $363,000 to $254,250.

In comparison, payments made from a superannuation fund to the dependants would be tax free therefore each dependant would receive $200,000. Non- dependants would be liable for between 15% and 30% tax, thereby receiving at least $140,000 after tax. The maximum total tax payable would be $180,000, being $74,250 less than the benefit payable from an employer owned policy.

4.4.4. Recommendation

Our recommendation is to treat the taxation of benefits, paid by an employer, in the same manner as benefits paid from a superannuation fund and to treat benefits paid to dependants, via an estate, in the same manner as benefits paid directly to the dependant. The taxation revenue loss is expected to be low. The removal of this major disincentive for employers to provide such benefits could result in higher death insurance coverage of the working population.

5

SIMPLER SUPER AND OTHER EQUITY ISSUES

5.1. Introduction

As part of the Simpler Super changes from 1 July 2007, significant changes were made to superannuation tax law. At the same time as these changes were being made, much of the continuing relevant law was rewritten and moved from the Income Tax Assessment Act 1936 to the Income Tax Assessment Act 1997.

Although there was considerable discussion with industry on the changes, the legislative timetable for such a massive overall change, was extremely short and there was insufficient time for a full discussion. Further, not all industry proposals were accepted.

As a result, there are a number of features of the Simpler Super system which are creating considerable difficulties and concerns for superannuation funds.

Some of the major issues are set out below.

5.2. No-TFN tax

This tax is payable by superannuation funds in respect of contributions in respect of members who have not provided a Tax File Number (TFN).

The tax can be reclaimed at a later date (subject to time limits) if the TFN is supplied at a later date.

The major difficulty with this tax is that it is a liability and payable by the fund itself rather than the member who has not supplied a TFN. Where possible, trustees pass the impact of the tax onto the member.

Some of the problems arising because this tax is levied on the fund include:

- the member is less aware of the impact and hence is less likely to provide the TFN;
- when the member later provides a TFN, the fund incurs additional costs in reclaiming the tax from the ATO;
- where a member has already left the fund when the TFN is provided, significant additional costs are incurred in re-establishing membership in order to reclaim and pass on the tax;
- where a member provided a TFN on leaving the fund, the fund may refund the tax already paid at that time with the payment financed from the fund's reserves. The actual tax would be reclaimed later from the ATO. This effectively results in an additional financing cost to the fund;
- where an incorrect TFN has been provided (which might pass the TFN algorithm), the fund will expect that it is correct and not allow for the tax. If the member leaves the fund and the ATO subsequently advise that the TFN provided was incorrect, the fund will be left with a tax liability which cannot be recouped from the offending member;
- where a fund winds up, it may then be impossible for a member who subsequently provides their TFN, to claim back the no-TFN tax which has already been payable;
- the impact on defined benefit funds is totally unclear with much private legal advice disputing the ATO's interpretation of the legislation. The legislation provides no indication of how to calculate the tax in relation to a defined benefit fund.

It would be more appropriate for the no-TFN tax to be a liability of the member. If the TFN is not provided before leaving the fund, the fund could be required to withhold an appropriate amount so that Government revenue is not adversely impacted.

5.3. Transfers from overseas funds

The SIS legislation and regulations place a limit of $450,000 ($150,000 if aged 65 or over) on the amounts which can be transferred from an overseas fund. Larger amounts must be retained in the overseas fund, cashed (if possible) or transferred in smaller parcels (often not possible under overseas legislation and in any event can result in significant additional Australian tax on the transfer).

This limitation unnecessarily restricts the transfer of funds into the Australian superannuation system.

Other technical problems have arisen as a result of the transfer of this legislation from the 1936 to the 1997 Tax Acts.

5.4. Notional contributions for defined benefit funds

The Income Tax Regulations 1997 are extremely unclear as to how various situations are to be treated.

There are also many anomalies which result in extremely inequitable results for members.

This is leading to much confusion for superannuation fund trustees, members and the ATO.

5.5. Adding to an existing pension

Currently it is not possible to add amounts to an existing pension. At least for the new account based pensions, allowing additional amounts to be added would simplify pension arrangements. For example, a retiree could be receiving an existing pension and then return to work part-time for a period. During this period of employment, additional superannuation accrues but on retiring, the resultant benefit cannot be added to the existing pension unless the existing pension is commuted in full and a new pension commenced.

5.6. Definition of pension

The definitions of what constitutes a pension for tax purposes are set out in the SIS Regulations. However the requirements for defined benefit payments are extremely difficult to interpret and depending on how the requirements are interpreted could result in payments which have been treated as pensions for many years, technically failing the pension requirements.

5.7. Tax deductibility of employer contributions for former employees

Strict rules apply in respect of employer contributions made after an employee has ceased employment. Whilst not an issue in respect of SG contributions, if other contributions are paid late, then there is the possibility that these may not be tax deductible. This could include salary sacrifice contributions, voluntary employer contributions and contributions to fund an investment shortfall in a defined benefit fund.

With the significant reduction in asset values in recent months, many defined benefit funds are in need of an injection of additional employer contributions. In some cases (for example, a fund where the only remaining defined benefit members are former employees receiving a pension) it will not be possible for the employer sponsor to claim a tax deduction in respect of those additional contributions. This will act as a significant deterrent to additional employer contributions in some circumstances and may threaten the security of members' benefits.

5.8. Other unresolved issues

Two other issues which have been the subject of negotiation with the ATO for some time include:

- the tax deductibility to a superannuation fund of insurance premiums for disability; and
- certain aspects of how the exemption from tax of investment income on assets backing current pension liabilities should be determined.

There are concerns that the ATO will require changes to long standing industry practice in these areas.

5.9. Recommendations

Further consideration should be given to the above issues.

The significant problems listed above highlight the need for even greater and more effective industry consultation, together with longer implementation time frames, for major legislative changes.

5.10. Product Rationalisation

5.10.1. Current position

The capital gains tax requirements currently act as a significant barrier to the rationalisation of superannuation funds, particularly in the current environment.

When a superannuation fund winds-up with assets, liabilities and members transferring to another fund, there is a realisation of capital gains and losses.

Where there is a net realised gain, tax is effectively brought forward due to the merger.

Where there is a net realised loss, the value of any future income tax benefits is lost due to the merger. At the current time, with many funds suffering significant share market losses, there is a major disincentive to rationalising funds.

5.10.2. Recommendation

The government should provide rollover relief in respect of superannuation fund mergers at all times. Thus, where the merged fund took over the assets of the fund being wound-up, there would be no triggering of gains and losses at that point. The original cost base would continue to apply with applicable tax payable when the asset is eventually sold.

We note that similar provisions have applied at times in the past (eg in the period leading up to 1 July 2004 when it became necessary for trustees to become licensed by APRA).

MERCER

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Consulting. Outsourcing. Investments.

APPENDIX 1

26 September 2008

Submission on 2008 Pension Review

MERCER

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Consulting. Outsourcing. Investments.

Contents

EXECUTIVE SUMMARY

Mercer's submission concentrates on actions that need to be taken so that Australia can provide its citizens with an appropriate level of income in retirement on a sustainable basis and without unduly high taxes being applied to the working age population.

Mercer believes that any Social Security system needs to:

- provide an appropriate minimum level of income;
- be affordable over both the short and long term;
- be integrated with the tax and superannuation systems as well as Australia's workforce needs;
- provide the right incentives for appropriate behaviour by retirees and those re-entering the workforce;
- be simple to understand and administer.

There are a number of significant issues facing Australia in relation to the provision of Social Security benefits. These include:

- An ageing population
- Significant increases in life expectancy with retirees living considerably longer than ever before
- A need for older workers to remain in the workforce

The ageing population and greater life expectancy will place a strain on future Governments with the costs of the age pension increasing due to longer payment periods and with a smaller proportion of the population in the "working" age-group – ie the age group which is able to contribute the most to the tax system.

Getting the structure right in a three pillar system

Whilst the level of the Social Security benefits is extremely important, it is equally important to ensure that the structure is right.

Living in retirement is currently underpinned by a three pillar system made up of:

1. First pillar -the age pension

2. Second pillar -compulsory savings through the Superannuation Guarantee system

3. Third pillar - voluntary savings, including both superannuation and non-superannuation savings

At its current level of about 25% of Average Weekly Earnings, the single age pension does not provide a level of income that would be considered acceptable by the majority of the population. However, as the age pension is only one of the three pillars, this is not necessarily inappropriate – it is the combined value of the three pillars that needs to be taken into account.

It is worth noting that the latest OECD data which calculates net replacement rates (NRR) arising from mandatory pension programmes (ie age pension and Superannuation Guarantee for Australia) indicates that Australia is below the OECD average. This highlights the need to encourage voluntary savings.

Our recommendations to address the needs of Australia and Australian retirees in the future concentrate on the need for sustainability and how adequacy can be improved by further developments of the second and third pillars and thereby reducing the reliance on the age pension:

First pillar – the age pension age

Recommendation: Increase the age pension age and provide greater incentive to those able to work past age pension age

1. Increase the age pension age gradually from 65 to 67 from 2025 (Age 65 was first set over 100 years ago and has not been modified to reflect significant increases in longevity. An increase in this age would be consistent with changes made in a number of other developed countries. It would also encourage later retirement by those who are able to continue working. Those unable to work would be provided with either disability or unemployment benefits.)

2. Replace the current pension bonus scheme (which we consider to be overly complex and inequitable) with a new system in which earnings from personal exertion (up to a specified level) would be excluded from the income test for those over Age pension age. The mature age worker tax offset could also be removed from age pension age.

Second pillar – Superannuation Guarantee

Recommendation: Improve adequacy by removing some of the large gaps in the current coverage of the second pillar Superannuation Guarantee system.

This could be achieved by:

3. Gradually phasing the self-employed into the Superannuation Guarantee system.

4. Expanding the Superannuation Guarantee system to cover workers compensation benefits and paid parental leave.

5. Providing some form of additional Government assistance to the long term unemployed, disabled and carers (ie carers of young children, the sick and the aged) to make up for part of the Superannuation Guarantee these Australians do not receive.

Third pillar – voluntary saving

Recommendation: Improve adequacy by providing further encouragement to voluntary saving

This should be encouraged by:

6. Better education of workers and retirees which will require the simplification of financial advice requirements so that Australians can be better informed of the level of saving they will need for an adequate retirement income. This includes the provision of compulsory projections of benefits at retirement and beyond.

7. Introducing a soft compulsion strategy under which employers would automatically deduct superannuation contributions from the salary of new employees and from any salary increases for existing employees but with the employees having the option to opt out.

Options in retirement

Recommendation: Assist in the establishment of new products that will enable retirees to plan their drawdown from their savings more effectively

8. The Government should sponsor industry discussions to determine how the private sector could be much more involved in providing guaranteed lifetime income streams, including consideration of the necessary regulatory changes and the design of suitable Government securities that would enable the private sector to better match/ immunise their liabilities.

Whilst not analysed in detail in our submission, we consider that other changes worthy of consideration include:

1. Reassessing the relative treatment of homeowners and non-home owners. The differential between the assets tests for home-owners/non-home-owners does not reflect the value of homes in today's market. Further the Rent Assistance payment does not reflect current rents.

2. Reducing the reliance on regular means testing and simplification of the means testing system. Removal of the means tests for those over a certain age (say age 85) would be one means of simplification.

3. Increasing the single pension as a proportion of the couple's pension.

1

Introduction – Current Issues and Challenges

Terms of Reference

The Pension Review's three key terms of reference are:

- appropriate levels of income support and allowances, including the base rate of the pension, with reference to the stated purpose of the payment;
- frequency of payments, including the efficacy of lump sum versus ongoing support; and
- structure and payment of concessions or other entitlements that would improve the financial circumstances and security of seniors, carers and people with disability.

The Mercer submission does not consider what level of income constitutes an appropriate level of income for those on Social Security benefits.

Rather, it concentrates on actions that need to be taken so that Australia can provide its citizens with an appropriate level of income in retirement from all sources on a sustainable basis and without unduly high taxes being applied to the working age population.

The Mercer submission also considers how the structure of the system can be modified to improve the security of seniors, carers and people with a disability.

We stress that these issues need to be taken into account irrespective of the actual level of Government pensions.

Current structure of retirement provision in Australia

Living in retirement is underpinned in Australia by a three pillar system made up of:

- First pillar - the single age pension which provides an income of about 25% of Male Average Weekly Earnings
- Second pillar -compulsory savings through the Superannuation Guarantee system
- Third pillar - voluntary savings.

However there appears to be no clearly enunciated objective as to the proportion of retirement income expected to be sourced from each of these pillars.

The latest OECD data which calculates net replacement rates (NRR) arising from mandatory pension programmes (ie age pension and Superannuation Guarantee for Australia) indicates that Australia is below the OECD average.

For a person on average earnings, Australia's NRR is 56.4%. Whilst this is higher than NZ (41.7), UK (41.1%) and US (52.4%), it compares less favourably with the OECD average of 70.1%. Germany (58.0%), France (63.1%) have a slightly higher NRR than Australia whilst several countries including Austria, Greece, Netherlands and Turkey have an NRR in excess of 90%.

Calculations performed by Geoff Dunsford and Darren Wickham and reported in their paper "New Ideas for Age Pension Reform-Discussion Paper" presented to the Institute of Actuaries of Australia Superannuation Policy Forum in September 2008 produce similar estimates of Australia's NRR.

These figures indicate that Australians currently need to place more reliance on the voluntary third pillar than their counterparts in the majority of other OECD countries. As such, Government encouragement of voluntary savings is critical.

On the other hand, if significant improvements to the first and second pillars are introduced, there would be less reliance on voluntary savings.

First pillar

At its current level, the age pension does not provide a level of income that would be considered acceptable by the majority of the population. Whilst some Australians will have other income and assets, it needs to be acknowledged that some senior Australians will need to rely solely on the age pension in retirement.

To achieve an appropriate level of income in retirement, Australians will generally need to rely on their savings under the second and third pillars to supplement or replace the age pension.

Any consideration of adequacy must therefore take into account all three pillars rather than just the first pillar.

The greater the level of benefits obtained through the second and third pillars, the lower the age pension needs to be, bearing in mind that it must still provide an adequate minimum level of support for those who have no or little second and third pillar savings.

On the other hand, it should not be high enough to reduce the case for saving through the second and third pillars.

The means testing of the age pension automatically provides some level of discouragement to voluntary savings for retirement. However, this is often offset by the fact that the level of the age pension would not be considered as an appropriate level of income by many senior Australians. In other words, significant increases in the age pension may further reduce the incentives for workers to boost their superannuation savings. If such increases occur, it may therefore be necessary to suitably adjust (or remove) the means tests if it is desired to continue encouraging voluntary saving.

However, with significant improvements in longevity and an ageing population, we believe that a more radical change is necessary – ie increasing the age at which the age pension commences. This is covered in Section 2. Other issues concerning the first pillar are covered in Section 3.

Second pillar

The second pillar, the Superannuation Guarantee system, only commenced in 1992 and at a significantly lower level than the current 9%. As this system matures, it will provide a higher level of retirement income than that received by current retirees.

The introduction and expansion of preservation requirements through the 1980s and 1990s will also enhance the use of superannuation for retirement (as the leakage of superannuation benefits from the system on resignation is now very limited).

However, one of the major problems with this second pillar is that it does not cover a significant number of Australians for major portions of their lives.

In particular, the Superannuation Guarantee system does not apply to those who are:

- self-employed
- unemployed
- disabled
- on workers compensation
- caring for others (including those on parental leave, those looking after young children or elderly relatives)
- voluntarily not working.

We note that many of these people will also be unable to save for retirement on a voluntary basis meaning that there will also be significant gaps in the provision for retirement under the third pillar.

In looking at the adequacy of Australia's retirement system, consideration needs to be given to filling in the gap for many of these who are not covered by the Superannuation Guarantee.

We have considered this in more detail and provided a number of recommendations in Section 4.

Third pillar

For some retirees, the combination of the Superannuation Guarantee and age pension will provide an adequate level of retirement income. However, for many, this will not be the case and, additional voluntary savings will be required.

Nevertheless, despite some favourable tax treatment, at least for higher income earners, the level of voluntary saving is not as high as it should be.

There are a number of reasons for this. Firstly, Australian workers do not know what they will need in retirement and are unsure of what their current benefit entitlements will be. This emphasises the need for greater education on retirement and retirement needs.

Secondly, there is the problem of inertia. Commencing a regular contribution pattern requires decisions to be made and actions to be taken. Many people never get around to taking the required steps until it is too late.

In Section 5 we consider ways of solving these problems.

Increasing Longevity

One of the major issues Australia faces is that of its ageing population with retirees living considerably longer than ever before.

This will place a strain on future Governments with the costs of the age pension increasing due to longer payment periods and with a smaller proportion of the population in the “working” age-group – ie the age group which is able to contribute the most to the tax system.

A pension age of 65 also results in preconceptions by both employers and employees that age 65 is the latest age at which workers should retire.

This belies the facts that many 65 year olds are still capable of making a valuable contribution to the workforce.

Increasing the age pension age may not only encourage those who would otherwise retire at 65 to work longer, but may also encourage those who retire early to remain in the workforce for a longer period.

In Section 2 we consider this issue in more depth and include some recommendations on increasing retirement ages.

Integration with work

Some people are now capable of working long after their 65th birthday whilst others, particularly in certain “heavy” industries may need to retire at an earlier age.

Employers are also starting to realise the value of older employees and the need to retain them although there is still a need for greater education of some employers regarding the benefits of retaining older workers on either a full-time or part-time basis.

However, continuing to work after age 65 generally results in the loss of (or significant reduction in) the age pension. Whilst a pension bonus scheme is available to those who do continue working, the scheme includes a complex series of rules and, in our view does not produce equitable outcomes.

In Section 4, we analyse these issues in more detail and set out our recommendations to solve these problems.

Recent changes

In recent years two significant changes have assisted **some** aged pensioners. These were:

- the removal of tax on most superannuation benefits; and
- the reduction in the taper for the assets test.

However, these changes did not assist those with little or no superannuation or those with a low level of assets.

Current issues which particularly concern us include:

- the pension payable to singles (60% of the couples pension) which is likely to result in greater financial hardship for singles;
- the differentials in the assets test between those who own a home and those who do not – in particular the assets test for non-home owners has not kept pace with the value of homes
- the level of rental assistance provided to non-home owners which has not kept pace with rental levels.

We recommend that these issues be reviewed.

2

Modifications to Retirement Ages

In 2007, two Mercer employees prepared research papers which looked at retirement ages. The papers were:

- “Pensions for Longer Life” by Dr David Knox which was prepared on behalf of CEDA; and
- "Its time to abolish retirement (and here’s how to do it)" by Darren Wickham which was presented to the Institute of Actuaries of Australia 2007 convention.

David Knox argued that, as life expectancies increase and the workforce ages, it is time for Australia to abandon a fixed pension age in favour of a dynamic approach which links pension age and life expectancy. He promoted a gradual increase in the age pension age.

Such reform would:

- Change the community’s focus from the single age of 65
- Erode preconceptions about when workers are “too old” to work
- Continue the encouragement of increased labour force participation rates at older ages
- Reduce the call on workers’ superannuation savings in retirement
- Improve the long term sustainability of the Australian retirement income system.

Darren Wickham speculated that there are four reasons why people retire:

- People become disabled
- People have a preference for leisure over work
- Government policies (with union support) have encouraged people from the workforce
- Employers did not want older workers.

Wickham argued that retirement at an arbitrary fixed age does not make sense and that disability is a more appropriate trigger. He also argued that leisure (for those capable of working at older ages) should be funded by savings and not subsidised by the State.

Both papers acknowledge that there would still be a need for Government provided benefits for those who are unable to work due to disability, unemployment and for those who are no longer physically capable of continuing to work.

We also note that a number of other countries have already announced that they will be increasing retirement ages for the purposes of their social security programmes.

Some current changes that have already been announced include:

- The US is gradually increasing its normal retirement age for Social Security from 65 to 66 between 2002 and 2009 and then increasing it again from 66 to 67 between 2020 and 2027;
- The UK announced in a 2006 White Paper discussing their new pensions system that they will gradually increase their State Pension age from 65 in 2024 to 68 in 2046;
- Germany is gradually increasing its pension age from 65 in 2012 to 66 in 2024 and then to 67 in 2029;
- Denmark is increasing the age threshold for the public old-age pension from 65 in 2024 to 67 in 2027. Furthermore from 2025, the eligibility age will be directly linked to changes in life expectancy at age 60;
- Japan is increasing its age for access to the earnings-related component of its pension from 60 to 65 by 2025 for males and by 2030 for females;
- Increases in pension age that affect both men and women are being implemented in the Czech Republic, Greece, Hungary, Italy and Korea (OECD, 2007).

As the OECD notes “increasing pension eligibility ages will improve financial sustainability and retirement incentives.”

Other countries such as Iceland and Norway already have a standard retirement age of 67.

It therefore appears that there is a strong trend around the globe towards a retirement age higher than 65.

Recommendation

Increase age pension age

Mercer strongly supports an increase in the age pension age. To enable current workers to plan their retirement, any increase should be deferred and gradual. Australia has already had experience in gradually increasing the age pension age for females from age 60 to 65. The pension age for women will reach age 65 from 2014. A similar process could apply for any future increases in the age pension age.

We recommend that the pension age be increased from 65 to 67 in a series of gradual steps commencing 1 July 2025 when the age would increase to 65.5. This would not impact on those born before 1 July 1960.

The pension age would then increase by 0.5 years every 18 months and would eventually reach 67 at 1 January 2032.

We also recommend regular review of the pension age after 2032 in line with increases in life expectancy from the pension age. For example, the pension age should increase (or decrease) by approximately 50% of any increase (or decrease) in life expectancy from the pension age after 2032.

For example, if the life expectancy of an Australian 67 year old increased by one year between 2032 and 2040, the pension age should then increase to 67.5 for both males and females.

3

Other Modifications to First Pillar

Currently, many people retire before age 65. In some cases this is because they can no longer cope with the physical demands of their employment. In many other cases it is because they have accessible superannuation and other savings and can afford to retire. Of course, the utilisation of these savings may result in a higher age pension once they reach age pension age (for example due to their diminished assets).

However, the current age pension system tends to perpetuate the notion that people should retire by no later than age 65.

We consider that this idea is no longer appropriate. Some people are now capable of working long after their 65th birthday whilst others, particularly in certain “heavy” industries may still need to retire at an earlier age.

Further, whilst in earlier decades, employers were keen for older workers to retire early, this is now much less likely and in many cases, employers need experienced older employees. With the decreasing proportion of the population under age 65, this trend is likely to continue.

An increase in the age pension age may not only increase the number of workers who work past age 65, but it may also result in those who would have retired before age 65 working longer where they are able. In particular, those who expect to rely on the age pension may decide that they can only retire say 2 years before they will become eligible for the pension.

Further, the current age pension system discourages working past age 65.

- For those who are working past age 65, the impact of marginal tax rates and the income test on the old age pension can result in very high effective marginal tax rates.
- Whilst the Age Pension Bonus Scheme can provide some benefit for those who work past 65, we consider that the qualification requirements are too complex and too rigid. Further, the benefits are too skewed towards long periods of work after age 65.

Whilst an increase in the age pension age will assist in retaining a greater number of older workers in the workforce, due to the long deferral period necessary to implement such an increase, more needs to be done to encourage older workers to continue working in the short term.

Means testing

Any income earned whilst working past age 65 is subject to income tax. The income is also taken into account for the purposes of means testing the age pension.

This can result in high effective levels of marginal tax. Income in excess of $138 a fortnight is subject to the income test with any extra dollar of income resulting in a reduction of 40 cents in the age pension. Thus there is a potential effective tax rate of 40% PLUS the marginal tax rate on any income earned. Even for low income earners on a 15% marginal tax rate, the effective marginal rate can be 55%, although this is further complicated by the Mature Age Worker and Senior Australians tax offsets.

Pension bonus scheme

The pension bonus scheme involves a complex series of rules which include:

- the need to register in advance;
- the need to work at least 960 hours a year to satisfy a work test (which can create difficulties during periods of long term illness, death of a partner etc or for those working on a casual basis).

Bonuses can also be reduced considerably due to periods of sick leave, gifting and the receipt of other income.

The bonus is also heavily skewed to those who continue working for at least 5 years after age 65. For example, the maximum bonus payable to a single person who works until age 66 is $1,373.80. This compares with the potential loss of a year’s pension of over $14,600 for a single person. The maximum bonus payable if the person works to age 70 is $34,344.30. As such it provides very limited assistance to those who intend to only work until ages 66 or 67 although it is more generous for those who work until age 70.

Further, the bonus depends on whether or not the person qualifies for the age pension at the time of ceasing work. The bonuses are reduced in proportion to any reduction in the age pension due to means testing.

In our view, the complexities of the system and the weighting to long periods of work offer little real encouragement to continue working.

Recommendations

Exclude income from gainful employment from income test

In order to provide greater encouragement to work past the age pension age, we recommend that any income gained from gainful employment be excluded from income testing.

This initiative should be targeted at the less well off. Whilst most rich people who continue working would not qualify for the age pension anyway (due to the income and assets tests), the exclusion of income from gainful employment could result in some well-off workers qualifying for the age pension.

This could be further minimised by putting a cap on the level of gainful employment income excluded from the income test. For example, a cap of $40,000 could be applied.

Remove pension bonus scheme

If the above recommendation is adopted, then there would no longer be a need for the pension bonus scheme (although there will need to be transitional rules for those who have already registered for the scheme).

Further, it would also be possible to remove the mature age worker tax offset for those over age pension age.

4

Improving Adequacy by Removing Some of the Large Gaps in the Current Coverage of the Second Pillar Superannuation Guarantee System

As indicated in Section 1, the Superannuation Guarantee system does not apply to those who are:

- voluntarily not working
- self-employed
- unemployed
- disabled
- on workers compensation
- caring for others (including those on parental leave, those looking after young children or elderly relatives)

Those who fall into the above groups for long periods of time are significantly more likely to need to rely on the age pension rather than on the second and third pillar savings. Consideration therefore needs to be given to additional initiatives to assist these groups in their retirement.

Voluntarily not working

Those who choose not to work should not be eligible for additional assistance.

Self-employed

Whilst the self-employed can now access full tax deductibility for superannuation contributions up to $50,000 a year (higher transitional amounts apply to those over age 50), contributions for the self-employed are purely voluntary.

Whilst many self-employed make some provision for retirement, either through superannuation or by building up their own business, we believe that it is time for a greater level of compulsory second pillar saving be considered for this group.

When the Superannuation Guarantee system was introduced in 1992, it was based on contributions of 3% or 5% of earnings with the level of contributions being increased gradually over a 10 year period.

A similar phased implementation for the self-employed would eventually result in this significant portion of the community being more self reliant in retirement.

A possible implementation programme would be to commence from, say 1 July 2010 at a 3 % level. The contribution level would then increase by 1% every second year, reaching 9% from 1 July 2022.

Unemployed and those on disability benefits

Filling in the gap for the unemployed and disabled is a more difficult problem. Requiring the unemployed to save some of their current unemployment benefits is not feasible. Thus any savings for retirement must come from the Government.

A Government contribution of 9% of the unemployment benefit would add significantly to Government costs. However these costs could be limited if the additional support was only provided to the long term unemployed.

Those who are only unemployed for a short portion of their working life may still be able to save for their retirement during their periods of work.

Thus any additional contributions could be limited to individual periods of unemployment in excess of, say 6 months or where the total period exceeds 2 years.

Consideration would also need to be given to ensuring that these contributions could not be withdrawn from the superannuation system on financial hardship grounds as, otherwise, this would defeat the purpose of the Government contributions.

Workers compensation and paid parental leave

Currently workers compensation payments (where no work is performed) and payments in respect of parental leave are not included in the definition of Ordinary Time Earnings on which Superannuation Guarantee contributions are based.

In respect of workers compensation, this appears unfair as, if the person had not been injured or had not become ill due to an incident at a workplace, superannuation contributions would have been paid. Obviously this would add to the costs of employers. We would suggest that the contributions be paid by insurers and funded by higher workers compensation insurance premiums.

Paying Superannuation Guarantee contributions in respect of parental leave payments may be even more controversial. The higher costs would be borne by employers and such a requirement could discourage some employers from providing paid parental leave or alternatively providing a shorter period of paid leave.

As such, there are arguments to defer changing the requirements until paid leave becomes more common or more widely mandated.

Carers

A significant portion of the community is unable to work because they are required to care for the young, the disabled or the elderly. Not only do they forego the ability to earn an income but they also forego the ability to save for their retirement.

In some cases, it may be possible for some paid part-time work to be undertaken, but this may be considerably less than would have been undertaken if there were no caring responsibilities.

Any additional assistance for this group needs to acknowledge that it should also take into account periods where some limited paid work was undertaken.

Clearly, rules would need to be established and the person would need to justify their carer's responsibilities.

We suggest that caring responsibilities would automatically include the care of:

- one or more pre-school age children;
- a disabled child of any age.

Other forms of evidence would be required in relation to the care of the elderly etc. This would include evidence that the person being cared for needed that care and that the care was actually provided. Rules applicable to the current carers allowance may be suitable for this purpose.

Any additional support could also be means tested. For example it could phase out once the person's taxable income exceeds the maximum age pension. A family based means test could also apply to limit costs and minimise the opportunity for those with highly paid spouses from using the system.

The additional Government assistance could take the form of Government superannuation contributions during the caring period.

Recommendations

To address the above issues, we recommend that:

- the self-employed be gradually phased into the Superannuation Guarantee system;
- that the Superannuation Guarantee system be expanded to cover workers compensation benefits and paid parental leave;
- that consideration be given to either the Government making Superannuation Guarantee contributions in respect of unemployment and disability benefits for those who have been unemployed or receiving disability benefits for long periods of time;
- that consideration be given to the Government making some form of superannuation contributions for "full-time" carers who are looking after children under the age of 5, elderly parents and the disabled.

5

Improving Adequacy by Providing Further Encouragement to Voluntary Saving (Third Pillar)

Deciding on level of retirement savings required – need for greater education

A significant issue for current workers is ascertaining how much retirement saving is necessary. This is currently made more difficult than it could be due to the laws surrounding the provision of financial advice.

We would also support recent proposals for the greater use of compulsory projections of benefits through to retirement and beyond on a standardised basis. Current regulatory requirements create significant barriers to the provision of projections.

We note that ASIC is currently seeking submissions on simplifying the advice regime and we will be making a submission to that enquiry arguing for the greater use of projections (in a controlled environment) that can be provided without the need for Statements of Advice.

Whilst changes in the law now provide greater opportunities for retirees to retain their savings in the superannuation system post retirement, benefits can still be accessed and spent. Hence there is a continuing need to educate those who are retiring on how much of their superannuation should be spent and how much should be retained to provide long term income.

Greater education regarding the use of reverse mortgages is also likely to help those in retirement make better use of what may be their prime asset – the family home.

Soft compulsion

Commencing a regular savings and contribution pattern requires decisions to be made and actions to be taken and as indicated above, greater education is necessary to assist workers to determine the savings they will need to finance an adequate retirement income.

Many people never get around to taking the required steps until it is too late. Often this is just due to inertia, even though the person realises that they should be saving more for their retirement.

One approach which has been adopted overseas is what has been labelled “soft compulsion”.

Under such an arrangement, employers would be required to deduct a certain percentage of salary from employees’ pay.

Normally this would only apply to new employees or when an existing employee becomes entitled to a pay increase. It could also be introduced at a time of major tax cuts. In these circumstances, there would generally be no reduction in take home pay which makes the contributions more acceptable to the employee.

The employee would however be able to opt out of the additional contributions by notifying the employer, thereby offering individual flexibility.

Various opt-out models could be adopted including:

- the employee can opt-out after, say 8 weeks of contributions;
- the employee can opt-out at any time;
- the employee can opt out initially but not at a later point.

Overseas experience indicates that workers’ inertia means that a high proportion of employees do not opt-out. As such, retirement savings can be greatly enhanced.

Need for more suitable products in retirement

One of the major difficulties for retirees, even those who have been well educated in relation to their retirement needs, is to determine how long they will live and hence how quickly they can draw down their retirement savings.

Drawing down too quickly may result in the retiree’s savings running out and being forced to survive on the age pension.

On the other hand, drawing down too slowly may result in the retiree’s lifestyle being less attractive than it could otherwise have been, yet ending up with significant assets to be left to any heirs.

Whilst account based pensions have proved very popular and are an effective means of enabling retirees to continue to participate in a wide range of investments, they are subject to significant longevity risks as well as investment risk.

There is much to be said for guaranteed lifetime pensions and annuities which would enable retirees to plan their retirement with much greater certainty.

However, few superannuation funds are now able or willing to provide such pensions and many life insurers have pulled out of the lifetime annuity market. This is largely due to the low popularity of such annuities. Such annuities are unpopular because

- the annuity features are often unattractive compared with the greater flexibility of account based pensions
- the perceived high cost (a significant reason being the high level of reserves that the life office needs to maintain and difficulties in matching assets)
- concerns that, on early death, there will be nothing left to pass on to dependants (although many insurers allow the flexibility to choose annuities with a guarantee period of say 10 years).

Of course, as life expectancies increase, the cost of such annuities will also increase, making them even less popular.

We are aware that some life insurance companies are investigating or have already developed products that will provide some level of protection against longevity however we believe that more needs to be done.

We would encourage the Government to engage in discussions with the insurance/ superannuation industries to determine what changes are necessary to assist industry in coming up with more attractive lifetime products. For example, consideration could be given to:

- designing suitable government securities that life offices can use to better match/ immunise their liabilities;
- amending the regulatory requirements relating to pensions/annuities to accommodate hybrid account based pensions that provide some longevity risk pooling.

Recommendations

Greater education

Financial advice requirements should be simplified so that Australians can be better informed of the level of saving they will need in order to provide an adequate retirement income. This includes the provision of compulsory projections of benefits at retirement and beyond.

Soft compulsion

In order to assist employees to provide themselves with an adequate retirement, a soft compulsion strategy should be introduced under which employers would automatically deduct superannuation contributions from the salary of new employees and from any salary increases for existing employees but with the employees having the option to opt out.

Suitable retirement products

The Government should sponsor industry discussions to determine how the private sector could be much more involved in providing guaranteed lifetime income streams, including consideration necessary regulatory changes and the design of suitable Government securities that would enable the private sector to better match/ immunise their liabilities.

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