27 February 2009

Submission on Australia's Future Tax System

Retirement Income Consultation Paper

MERCER

MARSH MERCER KROLL
GUY CARPENTER OLIVER WYMAN

Consulting. Outsourcing. Investments.

Contents

1

Executive Summary

The most glaring problem with Australia's three pillar retirement income system is the poor level of integration of the three pillars - the age pension, compulsory savings via the superannuation guarantee (SG) and voluntary savings. Australia needs a cohesive vision that addresses the three pillars of our retirement system as a whole.

No single pillar could, or should, survive in isolation or be expected to provide Australians with a secure and comfortable retirement.

In other words, the Government needs to clearly set out the objectives for an overarching retirement income system that is equitable and fair and actually encourages Australians to remain in the workforce longer.

Without clear objectives, we could end up with a well-intentioned but piecemeal collection of initiatives that may make incremental improvements but will not address the overall adequacy, simplicity and sustainability of the total system.

Before the three pillars can be more effectively integrated, there are shortcomings in the current system that need to be addressed, including:

1. **The government needs to ensure that there is a positive reaction towards superannuation across all income levels.**

   One of the inequities of the existing system is that low income earners receive no taxation incentives as their employer SG contributions are taxed at the same or at a higher rate than their individual income.

   Improving equity for this group could easily be achieved by providing low income earners with a refund or rebate on their 15% contributions tax.

Greater simplification and removal of significant anomalies and barriers will also enhance the acceptability of superannuation and encourage its use, particularly by lower income earners.

2. The gaps in Australia's superannuation system need to be addressed to ensure that a larger proportion of Australians of working age are saving for retirement.

The structure of the Australian superannuation system is one of the best in the world, but the fact that it doesn't cover a significant proportion of Australians is a fundamental flaw.

The superannuation guarantee system needs to be expanded to include the self-employed, those on workers compensation and paid parental leave. Those who earn below $450 per month, those over age 70 and those under age 18 should also receive the SG.

As well, there should be a provision for additional Government assistance to the long term unemployed, disabled and carers to make up for part of the superannuation guarantee these Australians do not receive.

An important result of reducing the SG gaps across the community will be to enable much better integration between the three pillars in the future. Currently, holistic integration is difficult because many retirees have not been in the superannuation system.

3. Changes need to be made to encourage people to stay in the workforce longer, or at the very least, to not discourage workforce participation after pension age.

The recent financial turmoil, and its impact on superannuation savings, has further highlighted the need for greater flexibility in regards to retirement age as more people are either choosing or being forced to stay in the workplace longer. Many Australians are uncertain when, or whether, they can afford to retire.

The current age pension system effectively discourages people from remaining in the workforce after age 65. This is not sustainable for Australia. Many employers are already facing the significant issues related to an ageing workforce – as many employers lose skills built up over many years by retiring workers.

The current pension age was set 100 years ago and needs to be reviewed. Life expectancy has increased substantially over that time and the mind-set of many in the community that 65 is the retirement age. A gradual change to the pension age would help shift this mind-set.

To further encourage employment in later life, we have recommended that any income from paid employment (possibly subject to a cap) be excluded from any income test for the age pension. This is a move that will encourage, but not require, people to remain in the workforce longer, even if in part-time employment.

4. Developments are necessary to encourage superannuation pensions in retirement (rather than lump sums).

We consider it important that retirees use a significant proportion of their superannuation benefit in a way which provides an income for at least the majority of their life. We have therefore recommended that, either by compulsion or coercion, retirement benefits are predominantly taken in income form.

To assist in this process we consider that the Government and the superannuation industry work together to establish a more robust means of providing pensions which will give retirees more certainty of being able to achieve an income for life.

One approach which should be considered is the provision of a universal non-means tested pension from age 85 which would assist in planning for longevity.

Unless the above issues are properly addressed, it will be significantly more difficult to effectively integrate the three pillars of Australia's retirement system.

We have considered in detail the questions raised in the Consultation Paper and set out our responses in the following sections.

As a community, we currently have a great opportunity to improve the ability of Australians to save for an adequate retirement, encourage people to remain in the workforce longer, reduce reliance on the age pension and create a fairer and more sustainable retirement income system. This will be achieved by setting clear objectives and improving and refining elements of each pillar for the benefit of the entire retirement income system.

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. We also provide our own master trust, the Mercer Super Trust, which has approximately 270 participating employers, over 200,000 members and more than $13 billion in assets under management.

Other recent Mercer submissions on the Retirement Income System

To Henry Tax Review – dated 17 October 2008

To Harmer Pension Review – dated 26 September 2008 (a copy was attached to our submission to the Henry Tax review)

2

Responses to Consultation Paper Questions

Q1.1 In considering the future of Australia's retirement income system, which objectives are relevant in setting retirement income policy? Does the current system of the Age Pension and compulsory and voluntary savings meet these objectives? If not, how should the system be changed to meet these objectives?

We first consider the objectives for a Retirement Income System as proposed in the Consultation Paper and measure the current Australian system against these objectives**,** which we consider to be broadly reasonable. However, we consider that the objectives of equity and affordability (whilst broadly covered under the second objective of acceptability) have not been credited with the attention they deserve. We have elaborated more fully in our comments on Objective 2.

Objective 1: it should be *broad and adequate*, in that it protects those unable to save against poverty in their old-age and provides the means by which individuals must or can save for their retirement;

> The first pillar (Social Security age pension) provides broad coverage and protects the vast majority of Australians from poverty in their old-age.
>
> The second (Superannuation Guarantee (SG)) and third (voluntary saving) pillars provide the means by which individuals must or can save for their retirement. However the second pillar does not provide a sufficiently broad coverage as there are significant groups in the community who are not covered by the SG system. The third pillar is also effectively unavailable to those who cannot afford to save.
>
> The current gaps in the SG system need to be addressed if this objective is to be achieved.

Objective 2: it should be *acceptable* to individuals, in that it considers the income needs of individuals both before and after retirement, is equitable and does not inappropriately bias other saving decisions;

Whilst it should be acceptable to individuals, it should also be acceptable to the community; otherwise it will not last. In particular, the system must be affordable and not result in unacceptable tax rates for working Australians.

The current system is generally acceptable at an individual level and enables some transfer of income from employment years to retirement. However a better system of spreading of income through the retirement years needs to be developed so that second and third pillar benefits are not fully expended in the early years of retirement.

Whilst broadly equitable, there are still some major inequities in our system. In particular, equity could be enhanced by:

- providing greater incentives for lower income earners;
- removing some of the significant inequities relating to death benefits;
- removing some of the significant inequities relating to temporary and permanent residents; and
- by a more effective integration with the age pension.

It is also important to consider and outline the breadth of equity. For example, should equity include the likely availability of the age pension, the overall level of an individual's tax payments and/or other elements of the tax/transfer system? Narrow definitions of equity can lead to sub-optimal outcomes. Furthermore, if the objectives of equity are not clearly articulated, there is a danger that future analysis and decisions will be too narrow.

Whilst saving through superannuation has some clear tax advantages over most other forms of investment for some, but not all, Australians, these advantages must be considered in conjunction with the disadvantages of a general lack of access (preservation requirements), and concessional contribution limits.

We do not consider that investment in superannuation inappropriately biases other saving decisions. The above disadvantages of preservation and contribution limits will always restrict the willingness or ability of individuals to save through superannuation.

Further, superannuation funds themselves need to invest the contributions they receive. Such investment supports the various investment markets and infrastructure investments seeking capital. Hence a superannuation fund is just an intermediary rather than a particular type of investment. As a large investor it is also more likely to be able to and willing to support large infrastructure projects than isolated individuals. We therefore consider that encouraging the superannuation system actually helps the development of large projects and thereby improves Australia's future potential.

Another potential inequity is the treatment of the family home for age pension means test purposes. Ignoring the full value of the home (irrespective of the value) would appear to bias the system towards those with expensive homes. Consideration should be given to requiring owners of homes over a set limit to better utilise the value of their home before being able to claim an age pension.

Objective 3: it should be *robust*, in that it appropriately deals with investment, inflation and longevity risk;

Whilst the first pillar provides a robust lifetime inflation-linked lifetime pension, the second and third pillars do not. The second and third pillars are subject to the downturns of investment markets, generally provide no protection against longevity or inflation and, in some cases do not provide adequately for death or incapacity. The global financial crisis is likely to make retirees more risk averse, thereby increasing the demand for such products.

In fact legislation, in some cases, is so inflexible that it seems to be designed to prevent employers, trustees and individuals from providing or obtaining the products that will provide such protection. More work needs to be done by Government and the superannuation industry to develop more appropriate annuity products.

Any solutions adopted must be designed so that they are affordable to employees and employers whilst also being affordable to the community as a whole.

Objective 4: it should be *simple and approachable*, in that it allows individuals to make decisions which are in their best interests;

The current system clearly fails the simplicity test. From the individual's point of view, there are significant complex decisions which need to be made at all stages of the cycle. For example:

Contribution phase (after deciding that additional contributions are necessary to achieve a person's retirement income goals, the following questions need to be considered):

Do the rules allow me to make contributions and what are the contribution limits?

Will the contributions be tax effective?

Should contributions be made by salary sacrifice or from after tax earnings?

Should I be splitting my employer's contributions with my spouse?

Should I be contributing on behalf of my spouse?

Would it be better for voluntary contributions to be made by my spouse rather than me?

Point of retirement:

Should I take a lump sum or a pension?

How will my decision impact on my age pension?

Should I continue to work and if so, how will this impact on my age pension?

How can I reduce the potential tax payable on my death benefit?

In retirement:

If I need additional cash from my pension, should I take it as an income benefit or should I partially commute the pension (although both payments may be tax free, they will have a different impact on eligibility for the age pension)?

How can I ensure that my retirement benefit lasts for my lifetime?

These decisions are vital to maximise the individual's standard of living in retirement and yet the considerations are often so complex that few individuals can appropriately determine the best option without obtaining significant financial advice.

It is also overly complex for employers, trustees of superannuation funds and financial advisers.

We return to many of these issues in our response to Q5.1 with potential solutions suggested in the Appendices.

The complexity of the system also makes it unattractive and unapproachable for many individuals who are frightened of and ill-equipped to handle the decision making process and hence avoid decisions wherever possible.

Objective 5: it should be *sustainable*, in that it is financially sound into the future and detracts as little as possible from economic growth.

Because the age pension is means tested, this assists its long term sustainability considerably. However, with an increasing proportion of the population being of pension age, and considerably increased life expectancy, consideration needs to be given to increasing the eligibility age for this pension.

We have also considered comments by the World Bank

World Bank ("Averting the Old Age Crisis" 1994)

- Old age security programs should help the old by:
  - Facilitating people's efforts to shift some of their income from their active working years to old age
  - Redistributing additional income to the old who are lifetime poor
  - Providing insurance against the many risks to which the old are specially vulnerable.
- And they should help the broader economy.

Holzmann and Hinz (World Bank) ("Old Age Income Support in the 21st Century" 2005)

- The continued relevance of the main objectives of pension systems – poverty alleviation and consumption smoothing – and of the broader social goal of social protection
- All pension systems should, in principle, have elements that provide basic income security and poverty alleviation across the *full breadth* of the income distribution.

Against these World Bank criteria, the Australian system measures reasonably well. Its weak points relate to the redistribution of income to the old who are life time poor. Whilst this group will generally qualify for poverty relief through the age pension, many in this group would have been excluded from the SG system for much of their lives and would not have had the ability to make voluntary contributions.

Further, other than the age pension, there is virtually no insurance available against the risks of old age (including investment and longevity risks). This represents a major shortcoming of the current Australian retirement income system.

Conclusion

The three pillar system is a good start although several modifications are necessary before it can be claimed as a success. In particular:

- Coverage of the SG system needs to be broadened
- Greater concessions need to be provided to low income workers (whilst retaining concessions for higher income earners)
- There needs to be greater integration of superannuation with the age pension, although we acknowledge this is difficult at present due to the existing lack of coverage of significant sectors of the community
- More needs to be done in providing solutions to investment, inflation and longevity risk in retirement
- The system needs to be simplified considerably.

Q2.1 As the SG system matures, it will become a greater part of an employee's retirement income. What are the implications for individuals partially or fully excluded from the mature SG system (the self-employed, individuals with broken work patterns such as carers, women and migrants), and how can the retirement income system best accommodate these groups?

As the SG system matures, those who are long term participants will be significantly better off than those who have been excluded from the system for a significant portion of their lives. As such, there will be an increasing economic divide between the haves and the have nots in retirement.

In our submission to the Harmer Pension Review dated 26 September 2008, we recommended that:

The SG system should be extended to:

1. the self-employed (with a suitable phase in)
2. the unemployed and disabled (perhaps restricted to longer terms of unemployment/disability) and funded by the Government
3. those on workers' compensation (funded by higher workers' compensation premiums)
4. those on paid parental leave (funded by employers but with a suitable lead-in time so that it does not act as a discouragement to employers voluntarily offering paid parental leave)
5. carers of children and the elderly (funded by the Government and potentially means tested).

We also consider that it should be extended to other workers who are currently excluded from the SG system due to age (ie those age under 18 who are working less than 30 hours a week and those age 70 or over).

More detail on our recommendations can be found in our Harmer submission dated 26 September 2008, a copy of which was attached to our earlier submission to the Henry Tax Review dated 17 October 2008.

Immigrants and returning expatriates are also at risk of being exempt from the SG system. Whilst many of these individuals may have been able to accrue retirement benefits whilst working overseas, there are considerable difficulties in appropriately accessing their overseas retirement benefits from Australia.

As indicated in Section 5.3 of our earlier submission to the Henry Review, there are significant difficulties in transferring overseas benefits to Australia due to limits imposed by the SIS Regulations. In many cases, benefits will need to be retained overseas. This means that the individual could face significant uncertainty in retirement due to the exchange rate risk. Under Q5.1, we propose that these limits be removed.

Q2.2 Noting that the adequacy of the Age Pension is being considered by the Pension Review, what is an appropriate concept of adequacy for the retirement income system? Should it be to ensure there is a minimum level of income in retirement, to replace a proportion of income earned prior to retirement, or some other alternative?

As an absolute minimum, the age pension should provide an income sufficient for a person with no other means of support to avoid living in poverty. However, in a wealthy country such as Australia, we consider that a higher level of support than the mere alleviation of poverty should be forthcoming.

In our view, it is appropriate that a flat rate pension be provided rather than a proportion of each individual's pre-retirement income. A flat rate pension is not only simpler but can also be considered to add greater equity to the retirement income system.

As discussed further under Q3.2, the tax concessions available under the second and third pillars favour the wealthier members of the community (although as indicated in our response to Q3.2, removal or reduction of these concessions for higher income earners could have undesirable consequences).

On the other hand, a means tested age pension favours the lower and middle income sections of the community. (As the age pension is financed from general tax revenue, wealthier Australians are effectively meeting a significant share of the costs of providing the age pension whilst potentially obtaining no value from it.)

A flat rate means tested pension further tilts the scales in relation to the first pillar in favour of the lower paid.

Favouring the lower paid in relation to the age pension is reasonable in light of the concessions under the other two pillars.

Later in this submission we have also recommended that the age pension be provided to all from age 85 (or 20 years after pension age) in order to provide greater security against longevity, to encourage a more effective draw down of benefits throughout retirement and to remove the significant complexities of dealing with Centrelink at very old ages.

Q2.3 What should the role of the government be in assisting individuals to meet their retirement income expectations in relation to the support provided by the Age Pension, the level of compulsory savings and incentives to make additional savings? Should the role of government change as an individual's income increases over their working life?

Facilitation

The Government should provide a system that facilitates individuals reaching their retirement income expectations by:

- enabling a transfer of income from the working phase to the retirement phase (on a compulsory and/or voluntary approach);
- encouraging personal saving to ensure an appropriate retirement income.

Clearly one of the downsides in superannuation is that, once made, contributions are effectively locked in until retirement due to the preservation rules. This can be a significant barrier to convincing younger Australians to make voluntary contributions.

Nevertheless, the preservation requirements are an integral part of the system and should be retained.

No adverse retrospective legislative changes

One concern which is often raised is that the rules are always changing and that, even though the tax concessions currently *sound* favourable, no-body knows whether they will still be in place at retirement. The locking-in of contributions and the potential for future tax changes is a significant legislative risk for individuals.

Until recently, the legislative risk appeared relatively slight as there had been a bipartisan approach which has resulted in significant adverse changes only applying on a prospective basis. In particular, the increase in tax on benefits in 1983 included appropriate relief for benefits accrued up to that time. Further, the Government has indicated that the tax free status of benefits from age 60 is not within the scope of the current tax review.

The addition of contribution tax in 1988 and surcharge in 1996 both had a generally prospective impact.

However, recently the Government (with bipartisan support) introduced dramatic new legislation and regulations which has led to a very significant adverse impact on persons who have or have had a temporary visa.

In many cases, the tax payable on their already accrued benefits will increase from zero to 35%. It appears that the Senate ignored its own long standing protocols about passing retrospective tax legislation when agreeing to the Temporary Residents' Superannuation Legislation Amendment Act 2008, the Superannuation (Departing Australia Superannuation Payments Tax) Amendment Act 2008 and accepting the associated changes to the SIS Regulations.

Such significant adverse retrospective legislation supported by both the Government and Opposition throws major doubt on whether superannuation, which has already accrued, is safe from legislative risks.

In order to ensure the effective working of the three pillar system, a bipartisan approach to protecting accrued benefits from adverse legislative change must be adopted.

Support for those who can work

The original intention of the age pension was to provide support for older Australians who were no longer capable of working. With the increase in healthy life expectancy, many older Australians are still very capable of working beyond age 65.

This raises the question as to whether the age pension should be payable to those who choose not to work as opposed to those who are unable to work. We consider this further under Q4.1.

Government role over a life cycle

At younger ages, the main Government focus should be on facilitating and encouraging a savings culture. Whilst younger Australians who are purchasing a home and raising a young family may have limited potential to make additional superannuation contributions, the instilling of a savings culture at a young age is important. This is a major reason why we are recommending a soft compulsion contribution system (refer to response to Q3.1).

In middle age, where more savings options potentially exist, the Government should ensure that the system is flexible enough to accept additional contributions.

At ages closer to the eligibility age for the age pension, the Government should ensure that there is a reasonable degree of flexibility to phase into retirement.

From pension age onwards, Government initiatives should be targeted at ensuring that those still capable of working are encouraged to do so without being financially penalised. Refer to our response to Q6.2 for more detail.

Q3.1 Do the settings of the retirement income system, such as the level of SG and access to concessions, adequately consider the needs and preferences of individuals both before and after retirement?

There is likely to be an ongoing debate as to the adequacy of the level of compulsory superannuation – whatever the level chosen. For some the level may be too high whereas for others the level will be too low.

One of the significant advantages of the three pillar system is that the third pillar provides the flexibility for individuals to provide the level of income in retirement that they need. We consider that greater use of this third pillar should be one of the first steps taken in increasing adequacy in retirement over the longer term.

However to be successful for lower and middle income earners, the access to concessions needs to be improved. In our response to Q3.2, we have recommended that:

- greater tax concessions should be provided to lower income workers (eg a 15% tax rebate on contributions); and
- the upper income limit for co-contribution purposes should be increased.

However, we accept that many low to middle income workers are unlikely to take the steps to make voluntary contributions. Hence we recommend that a soft compulsion approach be adopted in relation to member contributions. We have explained this in more detail in Section 5 of our submission to the Harmer Pension Review.

Q3.2 Is the current level of superannuation income tax concessions appropriate and sustainable into the future? Are the current concessions properly targeted and, if not, how should they be reformed?

Clearly the concessions available under the second and third pillars are considerably greater for higher income earners than they are for lower income earners.

Whilst this may initially sound inequitable, it ignores the fact that the first pillar is much more heavily subsidised (through general tax payments) by high income earners (who may receive no benefit) than by low income earners. This provides some evening out in relation to tax equity.

However, we still believe that further equity can be achieved by increasing the concessions for lower and middle income earners rather than reducing concessions for higher income earners.

Concessions for high income earners should not be reduced

Without tax concessions, high income earners will not save through superannuation. Because superannuation is generally preserved until retirement, other more flexible, non-superannuation investment options will be chosen.

Some high income earners will look to their tax advisers to find new ways of minimising tax.

Many may simply decide to invest more heavily in the other concessionally taxed investment class – the family home, or in negatively geared assets such as rental housing. This could result in severe distortions in the housing market with higher home values, and decreased opportunity for lower income earners to become home owners.

Further, high income earners are often the leaders in the community. Many are looked up to by their junior colleagues. If concessions for high income earners are removed, this could lead to such earners providing a negative message to lower paid workers, potentially encouraging imitated behaviour. For instance, if a young lower paid employee asks whether his boss is making voluntary contributions and is told "no", then it is less likely that the lower paid worker will make contributions. What is good enough for the boss is good enough for him.

Additional concessions for lower and middle income individuals

In Sections 3.5 and 3.6 of our earlier submission to the Henry Tax Review we considered a number of suitable incentives which would assist equity and simplicity.

In particular we recommended that:

1. 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; and

2. A refundable tax offset (or additional Government contribution to superannuation) of 15% should be applied to any concessional contributions. The rebate could be capped at say $350 and phase out between income ranges of $26,000 and $30,000. In effect, this rebate would offset the contribution tax payable on the employer's SG contributions; and

3. 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 (also refer to our response to Q5.1).

Q4.1 At what age should an individual be able to access their superannuation and at what age should they become eligible for the Age Pension?

Eligibility for age pension

We recommend that the age pension age be increased gradually from 2025, eventually reaching age 67. 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 (a number of which were listed in our submission to the Harmer Pension Review). It would also encourage later retirement by those who are able to continue working.

Further adjustments to the age pension age could then be made based on changes in life expectancy.

It would however be necessary to continue to provide benefits prior to pension age for individuals who are disabled or unemployed and hence are unable to work. It should be noted that such provision is required prior to any pension age and does not, in itself, represent an argument not to increase the pension age in the longer term.

More detail on this was included in our earlier submission to the Harmer Pension Review dated 26 September 2008 which was also attached as an Appendix to our earlier submission to the Henry Tax Review.

Accessing superannuation

Under current law, superannuation can be accessed (on permanent retirement) at age 55 although the access age will increase gradually to age 60 by 2024. We consider that allowing some access to superannuation from age 60 is reasonable.

However, there is scope to restrict the portion of the benefit which can be accessed in order to discourage early retirement.

For example, some approaches to discourage dissipation of the retirement benefit before pension age could include:

- a compulsory approach where:
  - benefits (or benefits in excess of a particular level) must be taken in pension form; or
  - a maximum level of benefit payment or pension drawdown prior to pension age is applied; or

- a non-compulsory approach where lump sum benefits in excess of a certain level (even those taken after age 60) are taxed more heavily.

Q4.2 What is the role of individuals in dealing with investment and longevity risk in accumulating and drawing down their retirement income? Do financial markets provide the means to deal with these risks? If not, is there a role for government to address these shortcomings?

We believe that many individuals, during their working/saving phase, underestimate the savings needed to provide their required lifestyle in their retirement years.

On the other hand, retirees tend to take an overly conservative view of their life expectancy and hence limit the drawdown of their superannuation to "ensure" that it lasts for their lifetime, often forgetting the fact that there is an age pension that can "kick-in" as other income falls.

In other words, many retirees are not spending their superannuation as quickly as they should with the result that it will be left to their descendants.

The current system does not provide a suitable method for individuals of insuring against longevity, inflation or investment risks.

Governments have appeared to frown on employer provided defined benefit pensions by:

- effectively banning smaller defined benefit funds
- providing extremely ambiguous, complex regulatory requirements on the design of defined benefit pensions (many traditional and well designed pensions can no longer be provided due to the SIS Regulation requirements). Whilst this problem needs to be fixed, fixing it will not solve the problem as few employers are willing to provide such benefits.

Most life offices have exited the market for lifetime annuities due to poor sales. This has been caused by several factors including the lack of any legislative incentive, the unavailability of appropriate assets and the significant reserving requirements.

As indicated in Section 5 of our earlier submission to the Harmer Pension Review, where more detail is included, we consider that there is room for the Government to liaise with industry to determine how the private sector could be much more involved in providing guaranteed lifetime income streams. This would include consideration of necessary regulatory changes and the design of suitable Government securities that would enable the private sector to better match/ immunise their liabilities.

Other options include legislating that at least a portion (eg one-third) of any superannuation benefit must be taken in the form of an income stream which is payable to at least age 85 and the encouragement of variable annuities, which have proven very popular in the US.

Q5.1 In what ways does the retirement income system impose undue complexity and cost on retirees and workers? How could this complexity be reduced?

There are many complexities for workers and retirees. The major issues include:

Contribution issues:

- Should contributions be pre or post tax
- Contribution requirements for members age 65 or over

Benefit issues prior to retirement:

- Terminal medical condition
- Death benefits
- Financial hardship/compassionate grounds

Issues at or in retirement:

- Taxation of death benefits
- Adding to an existing pension
- Pension payments (commutation or income)

Special issues for workers moving from one country to another:

- Contributions for temporary residents
- Contributions for permanent residents
- Restrictions on transfers from overseas superannuation funds

We have included more detail and suggested solutions to these major complexities in Appendix A of this submission.

Whilst the above issues affect individuals directly, there are other complexities which impact more directly on trustees and employers. These complexities also increase the costs of running the retirement income system.

Some of the major complexities for trustees are:

- Notional contributions
- No-TFN tax
- No-TFN tax for defined benefit funds
- Deductibility of insurance premiums
- Anti-detriment

We have provided more detail and suggested solutions to these issues in Appendix B of this submission.

Some of the complexities for employers are:

- Difficulties with the SG system
- Tax deductibility of contributions
- Employer payments on death
- Reportable employer superannuation contributions

These issues, together with suggested solutions are covered more fully in Appendix C to this submission.

Barriers to Efficiency

The complexity does not stop there. Existing legislation provides many barriers to an efficient system.

These barriers include:

- Frequent and ad hoc amendments to compliance requirements;
- Complex and ambiguous legislation;
- Barriers to fund mergers.

For example, the barriers to fund mergers include:

- the inability to transfer unrealised capital losses to the merged entity (whilst the Government has proposed some relief, this is only for a limited period and involves costly and complex processes. In our submission to the Treasury on this issue, we have recommended a simpler process);
- the inability to transfer realised capital losses, realised and unrealised capital losses on revenue account and other carry forward losses (no relief currently proposed although in our submission to the Treasury we have recommended that these issues also need to be addressed);
- Simpler Super concessional contribution rules under which, following merger, an individual's notional contributions can increase significantly even where there is no difference in benefit;
- the recent Industrial Relations Commission decision to specify default funds in modern Awards will mean that employers will be unable to change their default fund to one which provides more efficient, better and/or cheaper fees for employees.

Q6.1 The Age Pension serves two roles, as a safety net for individuals who are unable to sufficiently save for their retirement and as an income supplement for many individuals who do save. What should be the role for the Age Pension and means testing in a future retirement income system and what impact does this have on its sustainability into the future?

Whilst means testing increases the sustainability of the system, it significantly increases its complexity. It also leads to manipulation of financial plans to maximise the opportunity to obtain some age pension and associated benefits.

From a pure simplicity argument, the age pension should **not** be means tested, however, this may not be sustainable.

Means testing also has an adverse effect on the workforce participation of Australians over age 65.

In order to provide greater integration of the three pillars, we believe that the following should be considered:

Provide a universal age pension to those age 85 or over by removing the means tests from that age

> This would greatly simplify the system for those of advanced years, many of whom would no longer be capable of dealing with Centrelink and have to rely on their family to look after their financial affairs.
>
> Further, having the surety of a non-means tested age pension from age 85 will give younger retirees greater certainty in making decisions about drawing down their superannuation in the early years of their retirement (refer to Q4.2).

Exclude income from employment from the income test

> Refer to our response to Q6.2 for more detail but this would provide greater incentives to continue working past age 65.

Once the current gaps in the SG system have been removed and all Australians have had the opportunity to save through the second and third pillars, further simplicity could be added by excluding superannuation assets and income from the age pension means tests.

Of course the above suggestions will impact on the cost and sustainability of the age pension. However it should be noted that the additional costs of a universal pension for those over age 85 are limited as the number of individuals at such ages is relatively small and many of them will already receive a part or full pension.

We have recommended under Q4.1 that the age pension age be increased. This would result in some offsetting savings.

Further administrative savings would be made due to the resultant reduction in the means testing regime.

Q6.2 In what ways does retirement income policy affect workforce participation decisions and what, if any, changes might reduce disincentives to work? Does the sustainability and cost of the retirement income system affect the workforce decisions of younger generations of workers?

The current means testing regime strongly discourages workforce participation by those over pension age. Whilst the pension bonus scheme provides some incentive, it is overly complex and inflexible to provide any satisfactory level of encouragement or support for older workers.

Workers over pension age are subject to very high effective marginal "tax" rates. Not only does the standard marginal tax rate apply, but at some income levels the effective tax rate is increased by a further 40% due to the reduction in the aged pension and the impact of the income test.

We have covered these issues in more detail in Section 4 of our submission to the Harmer Pension Review. In particular, we recommended that:

- Income from gainful employment should be excluded from the income test
- Subject to the above adjustment to the income test, the pension bonus scheme be removed after a transitional period. (This scheme is too complex, too rigid, too skewed to longer periods of employment after age 65 and provides limited encouragement to continue working. More detail on these problems is set out in Section 3 of our submission to the Harmer Pension Review.)

Consideration should also be given to modifying the income test for the age pension so that the pension is reduced by no more than 30 cents for each additional dollar earned in order to better integrate the tax and social security systems.

Whilst many high income earners would still be excluded from receiving the age pension due to the assets test, it would be necessary to consider whether the exclusion of income from gainful employment should be capped so that the benefits are more targeted towards lower and middle income workers including those who are working part-time.

Q6.3 What impact could financial intermediation have on the effectiveness of retirement income policy?

We consider that there may be opportunities for superannuation funds, employers and the Government to drive the behaviour of individuals in a manner designed to achieve a desired outcome.

Whilst a desired outcome can normally be achieved by the Government imposing legislative requirements, such additional requirements are often viewed negatively and can actually have a detrimental impact. For example, limiting the flexibility of retirement benefits (eg forcing retirees to take a significant portion of their benefit as an income stream) could discourage retirement saving.

Alternatively, a more subtle approach may result in the desired outcome of greater use of income steams without the negative connotations. In particular, greater use of default approaches (with opt-out provisions) should be considered. As many workers and retirees are unable to, or are scared to, make a decision, many are likely to accept any default decision made for them

Some examples include:

- Applying a soft compulsion approach to member contributions – employee inertia is likely to result in the contributions to be made with only a relatively small proportion of employees electing to opt out;
- Superannuation funds automatically rolling retirement benefits over to a suitable income stream product. Again, if no decisions need to be made by the retiree, the income stream is likely to "stick".

Appendix A

Complexity for Workers/Retirees

CONTRIBUTION ISSUES

Contributions (post or pre tax)

Employees who decide to make voluntary contributions must decide whether those contributions are to be from pre or post tax salary. The answer is relatively clear for those on high incomes who are not eligible for the Government co-contribution – pre-tax contributions are likely to be more tax effective. The answer is also relatively clear for those on very low incomes – post-tax contributions will generally be the most effective. However for many middle income earners the answer is not always clear. Post-tax contributions qualify for the Government co-contribution however pre-tax contributions are subject to a lower rate of tax. This decision is most difficult for those in the income band over which the co-contribution phases out. For many workers in this range, the optimal solution may be a mixture of post-tax and pre-tax contributions. However few workers would have sufficient knowledge to correctly determine the appropriate mix – even if they knew before the end of the tax year what their income to be counted against the co-contribution means test was going to be. Again, those who are able to pay for financial advice would be able to benefit from these complex rules.

Solution

All contributions should be tax deductible. This would remove the inequity for those that cannot arrange salary sacrifice arrangements with employers. The Government co-contribution could still be payable for low to middle income earners based on their "voluntary" tax deductible contributions.

As well as creating greater equity, it would also simplify the decision making of workers and avoid the current situation where those who know the system can maximise the tax effectiveness of their super.

Contribution requirements for members age 65 or over

The SIS Regulations provide four different age-based sets of rules for making voluntary contributions:

- Rules for those under age 65 (generally restriction free)
- Rules for those aged 65 to 69 (subject to a work test)
- Rules for those aged 70 to 74 (subject to a work test and some contributions prohibited)
- Rules for those aged 75 or more (prohibited).

Not only do these age based tests create confusion, the work-test is poorly designed (for those age 65 and older) in that it effectively requires regular voluntary contributions to cease each 1 July until the required work test has been completed. To satisfy the work test a person has to be gainfully employed for at least 30 hours in any 40 day consecutive period during the financial year and before the contribution is made.

As an example, consider a person who works seven hours every Monday. In 2009, they will meet the 30 hour test on 3 August, their fifth working day in the financial year. This means that no contributions could be made in July despite a continuous employment history. As well as creating confusion for employees, it also creates problems for employers who may need to vary payroll deductions every July (and again in August) each year. Employers may also need to temporarily suspend non-mandated employer contributions for a month each year for workers over age 65. Additional work is also created for trustees who may have to refund July contributions.

Further, the term "gainfully employed" is often misunderstood with funds receiving contributions from people who have been performing voluntary work or managing their rental portfolio etc. Again these contributions will need to be returned.

Solution

The contribution rules should be simplified:

- *the same rules should apply to all voluntary contributions for at least 10 years after age 65 (or pension age if this is higher than age 65);*
- *the work test should be made more practical (for example the test could be having worked at least 30 hours in any 40 day consecutive period in the current or previous financial year).*

Compulsory or mandated contributions can be made independent of age and without the need to satisfy a work test. However SG contributions are only mandated up to age 70 creating further confusion for employees and employers alike.

Solution

SG requirements should apply to all employees – not just those under age 70.

BENEFIT ISSUES PRIOR TO RETIREMENT

Terminal medical condition

At a time of severe stress, dying members are effectively required to make significant financial decisions that could impact dramatically on their benefit and the tax payable.

There are three significant issues these members must consider during this time:

Size of benefit

The benefit payable on terminal medical condition could be significantly lower than the benefit payable on death or even the benefit on permanent incapacity. The member must decide under which condition of release they should claim their benefit. For example, an insured benefit may not apply on payment of a benefit due to a terminal medical condition. (An insured benefit will only apply if:

- the member satisfies the fund's definition of permanent incapacity – may not be the case if the member is still capable of working or if there has not been 6 months absence from work; or
- the fund's insurance policy includes payment of the sum insured if the member suffers from a terminal medical condition. (Note that concerns over the tax deductibility of insurance premiums act as an active deterrent to funds providing insurance on the grounds of a terminal medical condition – refer below.)

Tax payable

Whilst the payment of a lump sum benefit will be tax free in the event of a terminal medical condition, tax on the eventual death benefit would be tax free if paid to dependants but could be taxed at up to 30% plus Medicare if paid to other persons such as adult children.

The member must therefore consider who the beneficiaries of the death benefit are likely to be before being able to ascertain the most tax effective approach.

Other tax benefits

It may be possible for the trustee to augment the death benefit with an anti-detriment payment. This will depend on the rules of the fund, the beneficiaries of the death benefit and the fund's ability to make an anti-detriment payment. Anti-detriment payments are not possible in respect of benefits payable due to a terminal medical condition.

In other words the member could receive a significantly lower benefit on terminal medical condition than if the benefit had not been claimed until death. At a time where they are least able to make logical decisions, significant financial decisions have to be made. This highlights the need to obtain appropriate financial advice at this critical time.

Solution

This problem could be significantly reduced if:

1. *The same treatment of anti-detriment applied irrespective of whether the benefit is payable in account of death or terminal medical condition. That is either:*
    - *the anti-detriment provisions were extended to payments on account of a terminal medical condition AND the legislation on anti-detriment payments were amended to allow all funds to more easily provide such payments; or*
    - *the anti-detriment provisions were removed entirely; and*
2. *The provision of insured payments on terminal medical condition were encouraged by clearly making insurance premiums for such coverage tax deductible and by making a rebate available for the anti-detriment payment (rather than a tax deduction) to make it easier for all funds to make such payments (refer to Appendix B on complexities for trustees).*

Death benefits

The tax on some death benefits creates considerable inequities. In some cases, significant reductions in tax can be achieved by separating superannuation into two funds, one which holds almost all of the member's account balance and the other which includes the member's insured component (refer to Section 4 of our earlier submission to the Henry Tax Review for further detail).

Solution

Remove tax on all death benefits.

Financial hardship/compassionate grounds

Whilst members may be able to access benefits on financial hardship or compassionate grounds, such benefits, at least those paid before preservation age are subject to tax of up to 20% plus Medicare. If these benefits had been retained in the superannuation system to preservation age they would generally be paid tax free. Thus there is a significant tax penalty which must be considered before accessing a benefit on these grounds.

We consider that it is unreasonable for those who are most financially vulnerable are subject to this significant tax impost if they need to access their benefit. The tax will result in less money being available to meet their financial hardship needs.

Further, prior to Simpler Super, members could access their financial hardship/compassionate benefit from their undeducted contributions component on a tax free basis. Following the introduction of Simpler Super, all benefits must be taken proportionately from the various tax components. In other words, the Simpler Super changes have made superannuation less tax effective for the some of the most vulnerable in society.

A further problem arises in relation to members on Work Cover since the introduction of Simpler Super. The amount withdrawn is taken into account in determining Work Cover payments. Previously where the member had an undeducted contribution component of their benefit, they could have been withdrawn from that component and Work Cover would have been unaffected. As it is no longer possible to choose components, any superannuation withdrawals will affect Work Cover.

Solution

This problem could be minimised by enabling such benefits to be taken first from any tax free component. This would at least return the tax position to a basis broadly similar to the pre-Simpler Super laws.

The problem could be removed completely by making payments on account of financial hardship/compassionate grounds tax free and by ignoring such withdrawals in assessing Work Cover payments.

ISSUES AT OR IN RETIREMENT

Taxation of death benefits

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.)

For a retiree age 60 or more, decisions will often need to be made about cashing their death benefit just before death (tax free) or potentially being subject to tax on the eventual death benefit. These decisions have to be made at a time of stress or when the member is no longer capable of making logical decisions.

Whilst the problems are most extreme in the retirement phase, the taxation system can also result in significant inequities for members under age 65.

Yet many retirees can avoid this potential tax by cashing their benefit and re-contributing it as an after tax contribution at the time of commencing a pension (subject to various contribution limits and age limits). In other words, retirees who obtain financial advice would generally be able to remove or significantly reduce the potential tax on their eventual benefit. It is our experience that this issue is covered in virtually every financial plan prepared for retirees. Those who are prepared to pay for financial advice can take advantage of this re-contribution strategy whilst those who do not receive financial advice may be unaware of the potential tax savings. No doubt some retirees do not take up such a strategy for fear that it would be considered to be tax avoidance.

An additional complexity is comparing the advantages of a re-contribution strategy with the benefit of an anti-detriment payment on death which can only apply in respect of the taxed element of the death benefit. Members who receive are advice are able to determine the best course of action for the circumstances, while others are simply left to deal with the tax consequences.

We provided further elaboration on these issues in our submission dated 17 October 2008 together with a number of examples which highlight these problems.

Solution

This problem could be easily solved by at least making all death benefits payable from age 60 tax free.

Extension of the tax free status of death benefits to all ages would further reduce the inequities applicable on death.

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. Aside from the costs associated with facilitating a new pension, such commutations can sometimes result in adverse consequences from the point of view of the Social Security income tests. Again appropriate financial advice would be needed to determine whether it is better to commute and commence a new pension or to commence a new pension with the additional amount and leave the existing pension intact. Of course this would lead to duplication of fees.

We suspect that the complexities of these requirements lead to some retirees deciding to take the additional amount as a lump sum and spend it rather than adding it to their retirement income.

Solution

The pension system should be simplified by allowing additional amounts to be added to an existing account based pension.

Pension payments (commutation or income)

Age pensioners with an account based pension need to consider carefully how to take benefits in excess of the minimum pension. For instance, an additional pension payment could lead to a reduction in the age pension. On the other hand, commuting part of the pension will not result in an immediate reduction in pension but could lead to reductions in future years. Again, complex financial planning advice is necessary in order to determine the most effective means of making withdrawals from the pension. Those who are prepared to pay for financial advice are likely to obtain more favourable outcomes than those who do not.

Solution

Greater consistency in the treatment of income stream payments and commutations is required in relation to the income testing of account based pensions.

SPECIAL ISSUES FOR WORKERS MOVING FROM ONE COUNTRY TO ANOTHER

Temporary residents

Superannuation (including SG contributions) is totally ineffective for temporary residents following changes to the Superannuation (Unclaimed Monies and Lost Members) Act and the SIS Regulations in late 2008.

Not only will employer contributions be subject to 15% contribution tax, the resultant benefit received after leaving Australia will be subject to 35% tax in Australia and potentially further tax in the new country of residence. For almost all temporary residents this will result in tax which is significantly greater than the tax they would have paid if the contributions had been taken as salary or wages.

Admittedly the decision for the temporary resident is relatively simple, if the rules are known – voluntary contributions, either on a pre or post tax basis, should not be made.

The difficulty is that the rules will generally not be known and inappropriate decisions will be made based on the rules applicable to Australians (ie the temporary resident may decide to contribute because he is following the lead of his Australian colleagues).

Temporary residents who do learn about the special rules, will not make voluntary contributions. This will lead to a non-savings culture and we expect that they will be less likely to elect to contribute if they subsequently become a permanent resident.

Solution

Significant changes are necessary to the new legislation regarding temporary residents.

Permanent residents

Following the changes to the rules for temporary residents referred to above, many permanent residents have been placed in a difficult situation. If their circumstances change and they cease to be a permanent resident, their benefit will be subject to an additional tax of 35% on top of the 15% contribution tax already paid and any tax applicable in their country of residence. (Generally double tax agreements do not cover such payments.)

The new legislation is extraordinarily complex.

Where the permanent resident has also held a temporary visa at any stage, it will no longer be possible for such members to leave their benefit in the Australian superannuation system until age 60 after leaving Australia. Hence it will not be possible to receive the benefit free of Australian tax (unless they can somehow maintain their permanent visa by regularly returning to Australia). Rather, their benefit, if not claimed will be transferred to the ATO. It will not earn any interest and will be subject to the extreme tax rate of 35% when eventually claimed from the ATO.

The new law does not directly affect those permanent residents who have never held a temporary visa. They are able to forego their permanent residency status without impacting their ability to leave their accrued benefit in the Australian superannuation system and eventually take a tax free benefit after age 60. However if such members return to Australia on a temporary visa to visit friends or just as a tourist, they are then caught by the new legislation and the 35% tax will subsequently apply. This will act as a severe deterrent for such permanent residents ever returning to Australia on holiday (assuming that they know about these extraordinarily unreasonable laws). In other words, a holiday in Australia could have very severe financial consequences.

These complex rules are unlikely to be understood or realised by these permanent residents unless they receive appropriate financial advice.

However, as a result of these changes, we expect that permanent residents are less likely to make voluntary superannuation contributions in light of the extreme taxes that can be imposed retrospectively on their benefit if they forego their Australian residency. For those that remain in Australia, it will be more likely that they will have to rely more heavily on Government support in retirement.

Others will be shocked to find that the higher tax rates apply whilst others will be encouraged to manipulate the system by continuing to return to Australia on a regular basis in order to maintain their permanent residency status.

Solution

The relevant changes to the Superannuation (Unclaimed Monies and Lost Members) Act and the SIS Regulations should be repealed or at least very significantly modified in order to enable a fairer treatment of former permanent residents by enabling benefits accrued whilst a permanent resident to be immune from these changes.

Restrictions on transfers from overseas

As indicated in Section 5.3 of our submission dated 17 October 2008, 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. However cashing or breaking up the benefit is often not possible under overseas legislation. Further, where the whole benefit is transferred, the member can elect to transfer the tax liability to the superannuation fund (15% tax). This is not possible if only part of the benefit is transferred resulting in tax of up to 45% plus Medicare on the taxable portion of the transfer.

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

Solution

This problem could be solved by removing such transfers from the definition of fund capped contributions and in effect allowing larger transfers to occur.

Appendix B

Complexity for Trustees

Notional contributions

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.

Solution

Effective consultation with the Institute of Actuaries of Australia should be undertaken and regulations amended to remove inequities and ambiguities and provide clarity.

No-TFN tax

We discussed a number of the problems of no-TFN tax in Section 5.2 of our submission dated 17 October 2008. In particular, this tax is unfairly applied to the superannuation fund itself rather than the member who has not supplied their TFN.

As indicated in that submission, this tax results in additional costs for the superannuation fund which must be passed on to other members.

It is also a barrier to efficiency as the no-TFN tax can only be reclaimed by the fund which incurred the tax initially. This makes it more difficult for a fund to merge with another fund for efficiency reasons as the new fund will not be able to reclaim any no-TFN tax paid by the former fund for members who subsequently provide their TFN.

Solution

No-TFN tax should apply to the member, not the fund.

No-TFN tax for defined benefit funds

The situation is even worse for defined benefit funds. Whilst, at best, the legislation is unclear, the ATO have decided that no-TFN tax applies to defined benefit members. This is despite the fact that neither the legislation nor the regulations actually specify how to calculate the tax.

The ATO have specified one method which would be acceptable, however this can only be calculated with very significant difficulty and cost. It can also result in very inequitable results. In fact it is effectively unworkable.

The ATO have also indicated that they will **not** accept the only sensible and logical method which is relatively straightforward to apply.

Solution

The legislation should be amended to specify that the no-TFN tax is based on the notional concessional contribution rather than on a proportionate allocation of all contributions.

Alternatively the ATO should immediately announce that it with accept calculations based on the notional concessional contribution rather than on a proportionate allocation of all contributions.

Deductibility of insurance premiums

Despite the Explanatory Memorandum to the Simpler Super legislative changes stating that there were no changes to the tax deductibility of insurance premiums, a close analysis of the Simpler Super legislation clearly indicates a significant change from the practice adopted by all funds since the introduction of contribution tax in 1987. Whilst the ATO claims that the whole industry has been misinterpreting the previous legislation for nearly 20 years, it would appear that the ATO has never challenged a tax deduction claimed by any fund on these grounds. In fact we believe that in the early stages after the introduction of contributions tax, the ATO clearly accepted the deductibility of all insurance premiums for lump sum disability coverage and hence supported the standard industry approach.

We are aware that discussions have been underway between the industry and the ATO for many months. However the ATO has still not come out publicly with its concerns. In effect this places virtually every superannuation fund in a dilemma as to the tax payable and how the impact of any tax can be passed onto members.

In particular, the concerns relate to insurance policies which include:

- An own occupation (rather than any occupation) definition of total and permanent disability;
- Definitions of total and permanent disability which include payment of the sum insured if the member loses two limbs;
- (And more recently), policies which include payment of the sum insured on the grounds of terminal medical condition.

Continued delay in the ATO coming out with a ruling is creating significant disruption in the industry. Whilst some in the industry have directly approached the Government to resolve this issue, the Government has apparently decided to take no action until the ATO comes out with a Ruling.

Solution

This issue needs to be resolved immediately. The Government should immediately announce that it will amend the Income Tax Assessment Act (1997) to provide:

- *Deductibility for total and permanent disability premiums on the basis accepted by the industry (and effectively the ATO) for nearly 20 years;*
- *Deductibility for terminal medical condition premiums.*

Anti-detriment

This issue was covered in detail in Section 4.3.2 of our earlier submission.

Solution

Repeal the provisions with the savings used to finance the removal of tax on all death benefits; or

Modify 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.

Appendix C

Complexity for Employers

The SG system

In sections 2.3, 2.4 and 2.5 of our earlier submission to the Henry Tax Review, we highlighted a number of significant problems for employers in relation to the SG system. We refer you to that submission for further details however the difficulties are summarised below:

Definition of Ordinary Time Earnings (OTE)

This definition is too vague. Since making our earlier submission, the ATO has released a draft revised Ruling on what is included in OTE. In this draft ruling, the ATO has changed its view on what is meant by OTE in certain circumstances. This highlights the deficiencies in the current SG legislation where employers are expected to be able to interpret the legislation but where even the ATO does not have a consistent interpretation over time.

The ATO only proposes to enforce its new interpretations on a prospective basis (ie from 1 July 2009). However this will still leave employers and superannuation fund trustees in a very difficult position.

For example, as there has been no change in legislation, it can be argued that, if an item of remuneration is OTE after 1 July 2009, then it was also OTE in periods before 1 July 2009. Thus trustees of funds where the trust deed specifies contributions in terms of OTE or based on the SG requirements, may consider that they have an obligation to chase employers for contributions in respect of remuneration items which have newly been classified as OTE – not only in respect of future periods, but also in respect of past periods.

Further, unions may take action against employers where employers have not previously been contributing on the basis of the "new" definition of OTE.

Solution

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). Ideally this should include all earned income which will improve both simplicity and adequacy.

Payment of SG contributions

It is difficult for employers to be certain that their contributions are being paid on time, particularly when a Clearing House is utilised to assist in satisfying the employer's choice of fund responsibilities.

Solution

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

SG Statements

These are too complex and time consuming to complete.

Solution

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

Penalties are too severe

Multiple and severe penalties apply to even minor and unintended breaches.

Solution

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.*

Difficulties for international transfers and short visits by overseas executives

The exemptions for international workers available under the bilateral double coverage agreements are too limited, both in terms of the countries covered and the scope of the exemption provided.

Solution

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.

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.

Modern Awards

A recent decision by the Industrial Relations Commission has made it very difficult for employers to continue providing an effective and efficient default superannuation fund. The IRC has adopted an approach of specifying in Modern Awards, the default funds which can be used. Whilst default funds in place in September 2008 can continue to be used, employers will be unable to change the default fund (unless the new fund is also specified in the Award). In many cases, employers are keen to ensure that the default fund provides competitive services and fees and are prepared to undergo a competitive tendering process to achieve this. However, they will no longer be able to change the default fund to take advantage of improved offerings from another fund. The IRC decision is therefore likely to adversely impact on the employees' retirement income as the fees and services provided by the existing default fund may no longer be competitive.

Admittedly, employers may be able to put in place an enterprise bargaining agreement which can specify an alternative default fund. Whilst this may be appropriate for those employers who desire to put in place such an agreement for other reasons, it is not appropriate where there is no other reason to have an EBA other than for the purposes of specifying a default fund.

Solution

- *The IRC should reverse its decision to specify default funds in Awards; or*
- *the power of the IRC to specify default funds should be removed; or*
- *the default provisions in Awards should be made more flexible so that employers can choose a new default fund*

Tax deductibility

Employers are generally unable to obtain a tax deduction for non-mandated superannuation contributions made for former employees (refer to section 5.7 of our earlier submission). This can create significant financing difficulties, particularly in defined benefit arrangements where the security of pensioners' benefits may be at risk.

Solution

The tax deductibility rules need to be reconsidered to enable employers to claim a tax deduction in a wider range of circumstances.

Employer payments on death

Many employers would like to ensure that their employees have a satisfactory level of insurance coverage. Whilst, prior to Choice of Fund, this could have been provided through the employer sponsored superannuation fund, the Choice of Fund requirements have made this more difficult to achieve. The Simpler Super changes have also led to further difficulties for employers wishing to provide a cost and tax effective insured benefit for all employees. Further, the tax implications vary depending on whether benefits are paid directly to the beneficiaries or via the deceased employee's estate. More detail on these problems is set out in Section 4.4 of our earlier submission.

Solution

The taxation of benefits, paid by an employer, should be the same as benefits paid from a superannuation fund. Benefits paid to dependants, via an estate, should be taxed in the same manner as benefits paid directly to the dependant.

Reportable employer superannuation contributions

Tax Laws Amendment (2009 Measures No. 1) Bill 2009 proposes significant changes to income tests for numerous aspects of the tax/transfer system including a number of tests used in the retirement income system.

In particular, employers will be required to specify "reportable employer superannuation contributions" on payment summaries for periods commencing on or after 1 July 2009. These contributions will be added to other income for the purposes of the various income tests.

Whilst these changes have some logic and may improve equity, they will impose significant additional compliance costs on employers. We consider that the Government has significantly underestimated these compliance costs, which will include the costs of obtaining advice in order to understand the new rules, staff training costs, costs of amending payroll systems and so on. We also believe that the Government may have significantly underestimated the number of employers who will be impacted and or at least need advice as to the impact.

We consider that it is inappropriate to impose such additional costs (together with the additional time that will need to be devoted to understanding the new rules) on employers who are already suffering from the impact of the current global economic downturn. Further, there is simply insufficient time available for employers to understand and implement these new rules by 1 July 2009.

The Bill does not clearly define the amounts that employers will need to report. There are likely to be many situations in which the amount to be reported is unclear. It is also likely that a significant number of employers will report incorrect amounts. If the amounts reported are ever investigated by the ATO, then we expect that a high error rate will be found with the result that, in some cases, retrospective adjustments to multiple Government benefits, tax offsets etc will need to be made. Tis will increase the costs of the ATO and Centrelink whilst also creating potential hardship for individuals when benefits received are recouped by the relevant Government agency.

Further, the approach adopted has been largely a bandaid approach with additional amounts added to the existing tests. This means that there is not a consistent approach to determining the level of income for the various income tests.

Solution

The start date should be deferred until at least 1 July 2010 to provide sufficient time for employers to understand and implement the new requirements.

At the very least, all tests should be based on a consistent methodology. For example:

- *All tests should be based on taxable income rather than some tests being based on taxable income and others based on assessable income.*

- *All tests should be based on adjusted fringe benefits rather than some tests being based on adjusted fringe benefits and others based on reportable fringe benefits.*
- *All tests should be based on reportable superannuation contributions rather than some tests being based on reportable superannuation contributions and others based on reportable employer superannuation contributions.*

The requirements need to be clarified or preferably a much simpler alternative approach should be adopted. A more suitable approach was recommended in our submission to the Treasury dated 4 December 2008.)

MERCER

MARSH MERCER KROLL
GUY CARPENTER OLIVER WYMAN

Mercer (Australia) Pty Ltd
ABN 32 005 315 917
33 Exhibition Street
Melbourne Vic 3000
GPO Box 9946 Melbourne Vic 3001
61 3 9623 5555

Consulting. Outsourcing. Investments.