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8 May 2013

Subject: SUSTAINING THE SUPERANNUATION CONTRIBUTION CONCESSION

Dear Sir/Madam

Thank you for the opportunity to comment on the Exposure Draft of the relevant Bills. We also note our appreciation for the opportunity to meet with senior Treasury and ATO officials on this issue last week.

Executive Summary

We consider the most appropriate manner of implementing this new tax is the approach proposed in the exposure draft, in particular:

- Applying the tax to the individual rather than the fund
- Allowing members to access their superannuation to pay the tax
- Allowing tax in relation to defined benefit interests to be deferred.

This approach is superior, on efficiency and practicality grounds, to other methods which could have been adopted – in particular approaches which would have involved the tax being imposed on the fund.

However there are aspects of the Exposure Draft which could be improved and therefore need to be reviewed. Many of these relate to the application of the deferral of tax in relation to defined benefit interests.

It also appears the proposed tax will favour individuals in untaxed public sector funds compared with those in taxed schemes.

Our main concerns are set out below:

The method of determining notional contributions for defined benefit interests

Notional contributions for this purpose should be the contributions determined for excess contribution tax purposes although we understand these will not be subject to a grandfathered cap.

Tax deferral for defined benefit interests

Tax deferral should cease when:

- the member's superannuation interest no longer includes a defined benefit interest (whether a payment has been made or not)
- the member's defined benefit interest has partly been converted to an interest which is not a defined benefit interest (whether a payment has been made or not)
- the member has commenced a pension from the defined benefit interest

Exceptions to the above would relate to:

- the circumstances listed in 134-60(2)
- Family Law splits
- Non-successor fund transfers of defined benefits to another fund where the original defined benefit has not been crystallised.

Notification of request for payment of superannuation benefit (defined benefit interests)

The requirements for member notification of benefits becoming payable in section 134-110 are both unreasonable and impractical and should be removed.

Release authorities for deferred tax (defined benefit interests)

The provisions in relation to release authorities need to be simplified and expanded to enable:

- A member to use a release authority to pay the deferred tax from any fund in which they have an accumulation interest
- Such a release authority could be provided:
    - When the deferred tax is initially determined
    - When the ATO issues its subsequent notifications of the deferred tax updated with interest
    - When the deferral period ends

End benefit cap for defined benefit interests

In view of the complexities of such a cap, specific reference to the end benefit cap should be removed. However the ATO should have the discretion to waive any tax in excess of any amount which a member can prove is more than 15% of his or her post 30 June 2012 employer financed benefit. It is suggested the ATO could provide funds with examples where this discretion could be exercised.

If the cap is to be retained, then it should take into account early payments of the deferred tax (plus interest).

Assessment of interest (all interests))

Provided the member has provided the release authority to their fund and the fund has made the payment within the specified time frames, we consider no interest should apply. Further, for defined benefit interests the deferred tax should become payable 21 days after the Commissioner issues an assessment requesting payment – not 21 days after a benefit becomes payable.

System favours those in untaxed public sector schemes (mainly defined benefit interests)

To partly address this concern, the rate of interest applied to deferred tax assessments should be 85% of the long term bond rate for taxed schemes and 100% of the long term bond rate for untaxed schemes.

Death benefits (all interests)

Provisions should be included to allow assessments for the new tax and deferred tax to be met from their superannuation fund.

Death benefits should be excluded from income counted towards the $300,000 threshold.

Temporary residents (all interests)

Persons receiving DASPs should be eligible for a refund of the new tax paid in **all** years, plus interest.

Lack of indexation (all interests)

The $300,000 threshold should be indexed in line with other indexation within the superannuation system.

The tax is not universal (all interests)

The Government should find a means of applying this tax to all Australians earning more than the $300,000 threshold, i.e. including Federal judges and senior State public servants.

We have provided more detail on the above issues in Appendix 1.
Appendix 2 sets out more information on Mercer.

Please do not hesitate to contact us if you need further information by ringing John Ward on (03) 9623 5552 or myself on (03) 9623 5464.

Yours sincerely,

David Knox
Senior Partner

APPENDIX 1: DETAILED COMMENTS

The method for determining notional contributions for defined benefit interests

The Exposure Draft indicates the method of determining notional contributions is to be specified in Regulations. This is a major concern with the Draft as it would have been a simple matter to have specified the method by reference to the method of calculating notional contributions for excess contribution tax purposes.

Notional contribution rates for excess contribution tax purposes are already available for all private sector funds and many public sector funds. Using these factors will minimise costs whilst still providing a reasonable estimate of the cost of the employer financed component. Only a small number of public sector funds which do not currently need notional contribution rates would need to develop these factors.

We are particularly concerned with consideration being given to using the methodology developed for the superannuation surcharge in the 1990s. Using the surcharge methodology will result in:

- Significant additional costs for defined benefit superannuation funds in relation to the need for actuarial determination and certification of notional contribution rates and major systems programming changes
- These higher costs ultimately flowing through to higher costs for employers with the potential for some employers to cease providing defined benefits – to the detriment of remaining defined benefit employees
- Increased difficulties in communicating the relevant notional contribution rates to members due to the huge number of different rates applicable
- Considerable confusion for members with one notional contribution rate for excess contribution tax purposes and another for the purposes of this new tax
- A notional contribution rate which varies virtually every year for each member

We note the surcharge methodology resulted in multi-dimensional tables of notional contribution rates which were dependent on age, period of membership, sex, benefit category and other factors. This resulted in a huge number of different notional contribution rates.

Bearing in mind the above problems, the difficulties superannuation funds and actuaries faced in relation to the surcharge factors and the fact the new tax is only intended to impact on a very small percentage of members, we strongly oppose the use of the surcharge methodology for this purpose.

Recommendation

Notional contributions should be the contributions determined for excess contribution tax purposes although we understand these will not be subject to a grandfathered cap. We strongly oppose the use of the methodology used for surcharge purposes.

Tax deferral for defined benefit interests

We agree with the concept of deferring the tax payable in respect of defined benefit interests however there are some aspects of the exposure draft which need attention.

As currently drafted, deferral would inappropriately cease in the following circumstances:

1. a benefit is paid from an accumulation interest which forms part of the member's superannuation interest
2. a benefit paid to the member or the ATO under a condition of release in respect of an excess contributions tax assessment
3. a benefit paid to or rolled over to the member's former spouse as part of a Family Law split where the member retains a defined benefit interest
4. an income benefit is paid as a result of a member's temporary incapacity
5. a member's defined benefits are transferred from one fund to another in circumstances other than a successor fund transfer (for example there may be some differences in the defined benefits pre and post transfer and hence member consent to the transfer was required)

On the other hand, as currently drafted deferral would not cease (inappropriately) in the following circumstances:

6. a member's benefits are partly or fully converted from defined benefit to accumulation without a benefit becoming payable
7. a member becomes entitled to a crystallised benefit but elects to retain the benefit in the fund (the member may not have satisfied a condition of release or does not elect to take an immediate pension, a cash payment or rollover the benefit). (This will conflict with the situation where the member commences a pension, takes a lump sum or rolls over the benefit.) We note the meaning of the term "becomes payable" in proposed section 134-60 is very unclear however the Explanatory Memorandum indicates it means actually requesting a cash or rollover benefit.

Recommendations

We recommend the tax deferral cease when:

- the member's superannuation interest no longer includes a defined benefit interest (whether a payment has been made or not)
- the member's defined benefit interest is partly converted to an interest which is not a defined benefit interest (whether a payment has been made or not)
- the member commences a pension from the defined benefit interest

Exceptions to the above would relate to:

- the circumstances listed in 134-60(2)
- Family Law splits
- Non-successor fund transfers of defined benefits to another fund where the original defined benefit has not been crystallised.

This concept could be introduced by a significant rewriting of the deferral provisions or by making modifications to the draft as follows:

- Items 1 and 2 above could be addressed by referring to a benefit paid from a defined benefit interest rather than a superannuation interest in 134-60(2)

- Items 3, 4 and 5 could be addressed by including further exceptions in 134-60(2)

- Replacement of the term "becomes payable" with a clearer reference to a benefit actually being paid

- Wider changes would be needed to address Items 6 and 7 to enable deferral to cease when the defined benefit is fully or partially crystallised (including the commencement of a defined benefit pension).

Notification of request for payment of superannuation benefit

Proposed section 134-110 requires a member with a deferred tax liability to notify the Commissioner of any request for payment of a superannuation benefit. The Commissioner must be notified before the benefit becomes payable. Penalties apply for non notification on time.

These requirements are impractical and we expect an extreme level of non-compliance as the vast majority of members will either not be aware of, or will have forgotten the requirement even if this requirement is included on an annual deferred tax statement. Such a statement may have been received up to 12 months earlier and in any event, we expect many affected members will not understand the requirements. Members cannot be expected to be experts in tax law or financial services.

Further, the time between applying for the benefit and receiving the payment or rollover can be very short (perhaps only a day and often subject to the three business day portability provisions). This means funds, even if they are aware there is a deferred tax liability owing, will be unable to advise the member of the notification requirements in time for the member to comply. In any event, the benefit will generally have been paid before the ATO can issue a final assessment which means the member would have lost the opportunity to pay the tax from his or her defined benefit fund.

We note section 3.63 of the EM indicates the notice requirements will generally be triggered at retirement. This is clearly not the case in the private sector where the reporting requirements will generally be triggered when the member leaves the employer sponsor – most often, this is well before retirement.

It is also unclear how deceased members will be able to notify the Commissioner or how their legal representative (if one exists) will be made aware of the requirement to notify the Commissioner.

We note the fund is also required to advise the ATO of the payment. Advice by the fund should suffice.

Recommendation

The requirements for member notification of benefits becoming payable in section 134-110 are both unreasonable and impractical and should be removed.

This issue also relates to our other recommendations relating to:

- Triggering the ending of the deferral period to the time the defined benefit is crystallised (the fund would need to advise the ATO of this)
- Enabling members to use a release authority to pay the tax from their benefit in any fund.

Release authorities for deferred tax

We found the Exposure Draft and Explanatory Memorandum very confusing in relation to when a release authority could be used to pay the deferred tax. In particular it seems a release authority can only be provided in relation to payment of the deferred tax (when it becomes payable) to the defined benefit fund it relates to.

This is inappropriate as in many cases the benefit will have already been rolled over to another fund before the tax is paid. In particular, if a fund receives a portability request from the member it will have only 3 business days in which to make the payment. In other words, the benefit will have been rolled over before the ATO has even issued a notice of assessment. In some cases the payment will have been made before the ATO is even aware of the benefit becoming payable.

Recommendation

The provisions in relation to release authorities need to be simplified and expanded to enable:

- A member to use a release authority to pay the deferred tax from any fund in which they have an accumulation interest
- Such a release authority could be provided:
  - When the deferred tax is initially determined
  - When the ATO issues its subsequent notifications of the deferred tax updated with interest
  - When the deferral period ends.

End benefit cap

The Exposure Draft proposes an "end benefit cap" which will be calculated by the fund. As drafted, there are a number of difficulties.

Does not provide universal protection

Although there is some logic in this concept, it will provide a reasonable outcome only for those members who exceed the $300,000 income threshold in all years from 1 July 2012. It provides very limited if any protection for those members who only exceed the $300,000 threshold in some years.

The protection is also inadequate where a member has pre-paid their deferred tax debt.

Incorrect definition

It is our understanding the deferred tax will only relate to a member's defined benefit interest. Hence the cap should only relate to the defined benefit interest (not the whole superannuation interest as currently drafted – this will also include the member's accumulation interest, if any).

Calculation difficulties

Although the concept appears simple, there are a large range of benefit designs where the calculation will not be straight forward. This particularly includes a large proportion of defined benefit funds where the benefit will be the greater of a defined benefit and an accumulation amount.

Complications will also arise in relation to cases where there has been a Family Law split, a transfer of the defined benefit to another fund or part or all of the benefit is taken in pension form (a value of the pension will need to be determined).

It would appear necessary for all defined benefit funds to at least consider amending their administration systems to maintain/create additional records relating to each members' benefits as at 1 July 2012 and the member financed benefits from 1 July 2012 to assist in the calculation of the end benefit cap.

This change will effectively be required for every defined benefit member even if their income is well below the $300,000 threshold (in case they subsequently incur a deferred tax debt). Further, it will be required for all defined benefit funds even if it is unlikely any of their members will be affected.

Discourages early payment

The proposed capping mechanism ignores early payments of the deferred tax. This will discourage members from paying off their tax debt early. We note, in relation to the superannuation surcharge, many members were very concerned about their debt accounts and wanted to pay them off by either reducing their accumulation accounts or making additional contributions.

If a cap is to be applied, then it should also take into account early payments (plus interest) which have previously been made to pay off the deferred debt.

Reporting difficulties

In view of the complexities of calculating the end benefit cap, and the costs involved, we are concerned with:

- The short 7 day reporting period referred to in section 134-65 (30 days would be more reasonable)
- Any potential requirement to inform members either regularly or on request of their current end benefit cap (for example due to any direct or implied requirement in Corporations Law to provide such information)

Cap will generally not impact tax outcome

In most private sector funds, we expect the impact of the cap will be extremely limited with the associated administrative costs incurred by funds likely to outweigh the potential savings in tax by their members.

Recommendation

Specific reference to the end benefit cap should be removed however the ATO should have the discretion to waive any tax in excess of any amount which a member can prove is more than 15% of his or her post 30 June 2012 employer financed benefit. It is suggested the ATO could provide funds with examples where this discretion could be exercised.

If the cap is to be retained, then it should take into account early payments of the deferred tax (plus interest).

Assessments of interest

For accumulation interests, the new tax is due and payable 21 days after the Commissioner gives a notice of assessment (293-65) and the general interest charge is payable from that date (293-75). However the member may utilise the associated release authority and arrange for their fund to pay the tax on their behalf.

For defined benefit interests, the deferred tax debt is due and payable 21 days after “the Division 293 end benefit” is paid. However at that point the member is unlikely to realise the deferred tax has become payable.

Recommendations

Provided the member has provided the release authority to their fund and the fund has made the payment within the specified time frames, we consider no interest should apply.

Further, for defined benefit interests the deferred tax should become payable 21 days after the Commissioner issues an assessment requesting payment – not 21 days after a benefit is paid.

System favours those in untaxed public sector schemes (defined benefit interests)

The tax system relating to superannuation is extraordinarily complex. The proposed tax adds further complexities and inequities.

Compare two similar members, Member A is in a taxed superannuation fund, Member B is in an untaxed fund.

Member A becomes entitled to a benefit of $100,000 at retirement (tax free) and Member B a gross benefit of $117,647 (subject to 15% tax) resulting in a net of tax amount of $100,000.

Assume the notional contributions are the same for each member (which would be logical as Member A's notional contribution would be grossed up for contribution tax whilst Member B's would be based on a higher benefit) and the deferred tax debt at retirement amounts to $15,000.

Member A's benefit after applying the release authority to pay the tax would become $85,000. However, Member B's benefit would fall to $102,647 before tax or $87,250 after tax. In effect Member B's tax is effectively reduced by 15%. If Member B's total benefit exceeded the untaxed plan cap amount (currently $1,255,000), Member B's deferred tax would effectively be reduced by 46.5%.

In other words, the proposed tax will have a significantly lower impact on members of untaxed public sector schemes.

Clearly there is no obvious solution to this problem however one approach which would assist would be to adjust the rate of interest charged to deferred tax assessments. For example, the interest rate applied should reflect the different nature of funds with a net of tax rate being applied to member's in taxed schemes.

> ***Recommendation***
>
> The rate of interest applied to deferred tax assessments should be 85% of the long term bond rate for taxed schemes and 100% of the long term bond rate for untaxed schemes.

Our recommended approach would also be more consistent with the outcome which would have applied if the proposed tax had not been deferred and a debt account had been established in the fund and accumulated at the fund earning rate (ie a net of tax rate for those in taxed schemes.)

Death benefits

The exposure draft does not adequately cover death benefits either in relation to accumulation or defined benefit interests.

Firstly there appear to be no provisions for the deceased's legal personal representative to utilise a release authority to ensure the tax is payable from the superannuation fund – this is particularly important for defined benefit members where the deferred tax liability could be very substantial.

Secondly, a death benefit payable to a person who is not a death benefits dependant (as defined in Section 302-195 if the Income Tax Assessment Act) of the deceased will be included in their income for the purposes of the $300,000 income test. Hence, in the year of receipt, this may result in the person becoming liable for the new tax in respect of contributions made to their own superannuation. This appears to be unreasonable.

Recommendations

Provisions should be included to allow assessments for the new tax and deferred tax to be met from the deceased member's superannuation fund

Death benefits should be excluded from income counted towards the $300,000 threshold.

Temporary residents

It is appropriate Subdivision 293-G provides for a refund of the new tax where a person becomes eligible for a Departing Australia Superannuation Payment. This is reasonable as temporary residents are already subject to tax on their superannuation at close to the top marginal tax rate.

However, any tax incurred in a year in which the person was an Australian resident, but not a temporary resident, is not refunded. This is only likely to occur when a temporary resident obtains permanent residency status and subsequently loses that status. Nevertheless this can have very severe tax implications for their super which may have been accumulated over many years with the combined taxes significantly exceeding the top marginal rate.

Further interest is not payable on any refunds.

Recommendation

Persons receiving DASPs should be eligible for a refund of the new tax paid in all years plus interest.

Lack of indexation

We note the $300,000 threshold is not indexed. In other words this new tax will gradually impact more and more Australians. Future Governments will face ongoing pressure for the threshold to be raised.

Recommendation

The $300,000 threshold should be indexed in line with other indexation within the superannuation system.

The tax is not universal

It is undesirable and inequitable for any tax based on individuals to exclude a section of the community – in this case Federal judges and some senior State public servants. Although we understand there are constitutional reasons for this, this does not remove the resultant inequity and is likely to be of particular concern to those impacted by the tax. The apparent need for exemptions highlights the poor design of this tax.

Recommendation

The Government should find a means of applying this tax to all Australians earning more than the $300,000 threshold.

APPENDIX 2

WHO IS MERCER?

Mercer is a leading global consulting leader in talent, health, retirement and investments. Mercer helps clients around the world advance the health, wealth and performance of their most vital asset – their people.

Mercer also provides customised administration, technology and total benefits outsourcing solutions to a large number of employer clients and superannuation funds (including industry funds, master trusts and employer sponsored superannuation funds). We have $55 billion in funds under administration locally and provide services to over 1.3 million super members and 15,000 private clients. Our own master trust, the Mercer Super Trust, has approximately 260 participating employers, 240,000 members and more than $15 billion in assets under management.