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23 February 2009

Committee Secretary
Senate Standing Committee on Economics
PO Box 6100
Parliament House
CANBERRA ACT 2600
By email:

Subject: Inquiry into Tax Laws Amendment (Measures 2009 No 1) Bill 2009

Dear Secretary

Thank you for the opportunity to present our views on this Bill to the Committee.

However, we note our concern with the very short window of opportunity to make submissions to the Committee in relation to aspects of this Bill. The Bill, particularly Schedule 3, raises significant issues which should have significantly longer exposure to enable appropriate submissions to be made.

Our submission concentrates on Schedule 3 of the Bill (Reforms to Income Tests). We have also made some brief comments in relation to the changes relating to Temporary Residents Superannuation which will be further impacted by Schedule 2 of the Bill.

EXECUTIVE SUMMARY

Reforms to Income Tests

Whilst we do not disagree with the policy intent, we consider that:

- Now, in the middle of a global economic crisis, is not the right time to introduce this legislation which will impose significant additional reporting and compliance costs on employers.

- In the light of the current Henry Tax Review, now also does not appear to be an appropriate time to add significant further complexity to many aspects of the tax/transfer system. In particular we consider that the various income tests should be made more consistent with the same rules applying to all tests.

- Even if now were the right time, there is insufficient time for implementation and new systems to be installed by 1 July 2009. A lead time of at least 12 months would be necessary for employers to have any chance of properly implementing these requirements. In other words the new provisions should not commence before 1 July 2010.

- The requirements, as set out in the Bill, are too vague, and will result in the need for many employers to seek professional advice. It is also likely that many employers will not report correctly due to misunderstanding the requirements. Due to the lack of clarity, different advisers may provide conflicting opinions which will add further to the confusion.

- For defined benefit funds, the Bill is totally unclear as to how any amounts which must be reported are to be calculated and consideration should be given to excluding such arrangements from the new requirements.

We recommend that Schedule 3 of the Bill be deferred until after the Henry Tax Review panel has reported its findings and after the global economic crisis has passed with a commencement date of no earlier than 1 July 2010.

If the Bill is to proceed, then we believe that significant changes are necessary to make the proposal workable. In Part 1 of the Appendix to our submission to the Treasury on the Consultation Paper, we outlined how a more workable system could operate. We consider that our proposal, whilst not ideal, is far superior to that included in the Bill. A copy of our submission to the Treasury is attached to this submission.

Changes to Temporary Residents

We consider that the changes included in this Bill are of little consequence. However, we consider that the changes which have already been legislated (Temporary Residents' Superannuation Legislation Amendment Act (2008) and Superannuation (Departing Australia Superannuation Payments Tax) Amendment Act (2008)) together with amendments to the SIS Regulations which were registered in December 2008, have resulted in a significant retrospective increase in tax on the accrued benefits of former temporary residents. The changes have also increased administration and communication costs for superannuation funds, act as a significant deterrent to permanent residents making contributions, and provide many totally unreasonable outcomes.

COMMENTS IN MORE DETAIL

Schedule 3: Reforms to Income tests

As part of the consultation process, Mercer raised a number of significant issues related to the proposals set out in the Consultation Paper issued by the Treasury.

Whilst some of the difficulties arising from the process set out in the consultation paper have been addressed, not all have. We consider that the revised proposals set out in the Bill will also create significant difficulties for many employers.

Cost issues

Based on the requirements under the Bill, **all** employers will need to consider their reporting obligations.

Employers will need to decide whether:

- they do not need to report under the requirements of the Bill;
- they do need to report (in which case systems changes will be necessary);
- they do not know whether they need to report (in which case further professional advice including legal advice may be necessary).

Due to the vagueness of the legislation, we believe that a very significant proportion of employers will need to seek professional advice as to their responsibilities.

The Explanatory Memorandum estimates that compliance costs on employers in the first year alone will be nearly $57 million. The EM indicates that this is an estimate of potential direct compliance-cost impacts only and is a partial estimate of the potential compliance-cost impact.

In our view, the cost estimates shown are likely to significantly understate the costs to employers.

For example, the estimated costs of $648 for 25,000 small to medium businesses seem to be unrealistic. Even the cost of advice obtained in order to understand the new rules is likely to cost more than this estimate, let alone the costs of changes to systems, staff training costs and so on.

Further, the EM also ignores the cost impact on many hundreds of thousands of other small businesses who will also need advice as to whether or not they are impacted by these changes.

The estimates of ongoing costs ($33 a year for small to medium businesses) also seem to be totally inadequate.

In a time of global economic turmoil, many businesses are struggling to survive. To impose significant additional compliance costs on such businesses at this time would appear to be inappropriate.

Henry Tax Review

The Bill proposes changing the income tests for many aspects of the tax/transfer system. We note that the proposed income tests are not the same for each aspect. Rather we would be left with a complex web of different rules.

Considerable confusion is caused due to the different definitions of income and fringe benefits for the various tests.

It is unreasonable to expect that individual taxpayers will understand the subtle differences in the various tests.

The complexities involved in the multiple combination of tests also increase the need for financial and tax advice and the costs of obtaining it.

Rather than sticking bandaids on an existing system, it would be far preferable if implementation was delayed and these issues were considered by the Henry Tax Review.

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.

Implementation time

Employers will need to have new systems in place by 1 July 2009 so that appropriate Payment Summaries can be provided to employees who terminate on or shortly after 1 July 2009.

Bearing in mind that this legislation has not been passed, the significant confusion that employers will face, and the likely need for many employers to obtain advice, we do not believe that it is feasible to implement these changes effectively from 1 July 2009. As a minimum, we consider that a lead time of at least 12 months would be necessary for employers to have any chance of properly implementing these requirements. A date, no earlier than 1 July 2010 would be necessary.

Vagueness of the legislation

There are many circumstances in which the amount to be reported is not clear. Some examples are set out below:

Example 1: If the employer, for administrative reasons, decides to pay 9% of OTE for employees who earn under $450 a month and those under age 18 who work less than 30 hours a week, then it appears that the employer will not need to report these contributions for arms-length employees.

However it appears that such contributions **will** be reportable if the employee is an associate of the employer and can therefore “influence” the level of contributions. In other words, it would seem to be possible for different rules to apply depending on the status of the employee.

Example 2: The employer has agreed to pay contributions of 9% of OTE plus a matching $ for $ contribution made by the employee (with a cap). Where the employee can vary the level of their contributions, it is unclear whether the matching contributions would be reportable or not. One argument is that the rules are standard for all employees and the employee has had no influence over the contribution formulae. This is further supported by the fact that the employee does not obtain any other benefit in lieu of the matching employer contribution if the employee elects not to contribute to the fund. The opposing argument is that, because the employees can vary their contributions, they can influence the employer contribution and hence the matching employer contributions are reportable.

Example 3: The employer has a standard policy of contributing 14% of OTE. However, an employee can request a lower contribution be paid (no less than 9% of OTE) presumably to be replaced by higher salary income. Would it be argued that employees can influence the employer contribution? In this case, would all contributions over the SG requirements or Award requirements be reportable?

Example 4: The employer contributes 9% of earnings for all employees including those whose earnings exceed the maximum contribution base. The employer is approached by an Executive who asks that contributions be restricted to 9% of the maximum contribution base. If the employer agrees for this individual, would contributions for other executives on earnings in excess of the maximum contribution base be reportable?

The Bill is also unclear as to whether contributions to be reported are:

- those actually paid **in** the income year; or
- those which the employer actually paid **in respect of** the income year; or
- those which the employer **is liable to pay in respect of** the income year.

This needs to be clarified. Further comments on this aspect are included in Part 2 of the Appendix to our submission on the Treasury consultation paper (attached).

Further, no consideration is given to situations where the employer is on a contribution holiday and reportable employer superannuation contributions are being met from surplus rather than by actual contributions.

Defined benefit funds

The current Bill and Explanatory Memorandum make little reference to defined benefit arrangements whereas the Treasury Consultation Paper and consultation Bill included more detail. It is unclear whether the silence in relation to defined benefit funds is based on an assumption that members do not have the capacity to influence employer defined benefit contributions (and hence such defined benefit arrangements will generally not be caught).

However, it is our view that the Bill, as currently written, **does** apply to the employer sponsored portion of defined benefit arrangements.

Many defined benefit funds provide members with a range of contribution options, with each option potentially leading to a different level of employer support for the defined benefits.

For example, an employee may be able to contribute 0%, 5% or 8% of salary with each option resulting in a different level of employer sponsored defined benefit. The default contribution may be 5%. The employer sponsored portion of the benefit may approximate 9% for employees paying 0%, 12% for employees contributing 5% and 15% for employees contributing 8%.

If members choose the 5% or 8% option, then the employer cost is higher than the minimum employer cost of 9%. Would this give rise to any Reportable Employer Superannuation Contributions? Or would Reportable Employer Superannuation Contributions only arise in relation to any excess over the cost of the default option? Alternatively, if the employee is not entitled to any additional remuneration as a result of opting for a lower contribution rate, is the intention that no Reportable Employer Superannuation Contribution arises?

If a Reportable Employer Superannuation Contribution arises, how will it be determined? The Bill provides no method of calculation for such cases. In some funds, the employer contribution in the current year may vary according to the option chosen by the member whereas in other funds, an averaging approach may mean that there is no obvious contribution to report.

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Further, if defined benefit arrangements may give rise to Reportable Employer Superannuation Contributions no consideration is given to situations where:

- the employer is on a full or partial contribution holiday and reportable employer superannuation contributions are being met from surplus rather than by actual contributions; or
- the employer is contributing at a higher rate to make up for poor investment returns achieved in the last 2 years; or
- the fund is unfunded or partly unfunded.

In view of the complexities of defined benefit arrangements (refer also to Parts 5 and 6 of the Appendix to our submission to the Treasury), consideration should be given to excluding such arrangements from the new requirements.

Schedule 2: Unclaimed Superannuation Money

Some of the outcomes of the changes resulting from the Temporary Residents' Superannuation Legislation Amendment Act (2008) and Superannuation (Departing Australia Superannuation Payments Tax) Amendment Act (2008) together with associated changes to the SIS Regulations include:

- Former temporary residents who have left their superannuation in Australia will now be subject to 35% tax on their accrued benefit whereas previously they could have claimed their benefits tax free after age 60;
- 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;
- Not only does the new legislation result in the payment of a 35% tax (on top of the 15% contribution tax already paid), the former temporary resident may also be taxed in their new country of residence (it is rare for double tax agreements to cover lump sum superannuation benefits);
- Permanent residents, who have previously held a temporary visa, will now need to seriously reconsider whether they should make or continue to make voluntary contributions if there is any possibility that they might leave Australia in future. This could well lead to another underclass in retirement as these permanent residents are now less likely to save through superannuation. (A change in circumstances which may mean that they leave Australia and forego their permanent residency status will mean that they too will pay 35% tax on their superannuation unless they can continue returning to Australia to maintain their permanent residency entitlements);
- A permanent resident who has not previously held a temporary visa is not affected by the new rules, even if their permanent visa is cancelled. However, if they were to subsequently return to Australia on a temporary visa (eg on holiday), they would be subject to the new rules and the 35% tax rate rather than being able to take their benefits tax free after age 60;
- Former temporary residents who are trying to claim their Departing Australia Superannuation Payment before the increase in tax to 35% as from 1 April 2009, are finding that the ATO on-line system is "down" and unlikely to be back online before 2 March 2009. Whilst manual systems can still be used, this downtime of the online system makes it even more difficult for former temporary residents to take benefits at the current level of tax.

We believe that these new laws impacting on temporary residents are unreasonable.

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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.

We would be happy to elaborate further on our comments. In particular, we would be very pleased to present our views before the Committee in person. Please contact me on (03) 9623 5552.

Yours sincerely

JDWard

John Ward
Manager, Research and Information

ATTACHMENT

Copy of our December 2008 submission to the Treasury

Note that whilst the major issues in Part 4 of the Appendix to our submission have largely been addressed, as have some of our concerns raised in Part 7, most other comments in Parts 1, 2, 3, 5 and 6 of our submission to Treasury remain valid.

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4 December 2008

Income Reforms Team
Personal and Retirement Income Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: incomereforms@treasury.gov.au

Subject: Reforms to Income Tests – 2008-09 Budget Measures

Dear Sir

Thank you for the opportunity to comment on the Consultation Paper and draft Bill.

Executive Summary

Our submission concentrates on the issues relating to the inclusion of particular superannuation contributions in various income tests and the general complexity of income testing.

We support the general concept of including "salary sacrifice" contributions for the purposes of the various income tests as this would appear to improve equity.

However, we note that the proposals will result in a considerable increase in complexity and taxpayer confusion. We consider that the employer reporting process is overly complex and will result in a very high error rate as well as leading to excessive increases in employer costs. We believe that it is important to simplify the process considerably by:

- simplifying the reporting process (refer to item 1 below); and
- ensuring that the same definition of income is used for all relevant income tests (refer to item 3).

Our conclusions on these and other matters are summarised below:

1. Mercer simpler solution (refer to Part 1 of Appendix)

Mercer's simpler solution to achieve a similar outcome is as follows:

- Employers would report all employer contributions (other than defined benefit contributions)
- The ATO would determine an amount equal to 9% of the earnings shown on the employee's Payment Summary as an approximation to SG contributions
- The excess, if any, of the total employer contributions reported over the estimate of SG contributions would be the amount added to other income for income test purposes.

We have also recommended modifications to cope with those taxpayers who are self-employed or are entitled to defined benefits.

Recommendation

That the Mercer simpler solution be adopted in lieu of the proposals set out in the Consultation Paper.

2. Timing Differences and Payment Summaries (refer to Part 2 of Appendix)

The Consultation Paper and draft Bill are unclear as to whether contributions to be reported are:

- those actually paid in the income year; or
- those which the employer actually paid in respect of the income year; or
- those which the employer is liable to pay in respect of the income year.

This needs to be clarified. Irrespective of which approach is adopted, amendments will be necessary to the draft Bill to avoid the issues raised in Part 2 of the Appendix.

Recommendation

We have recommended that the contributions to be reported are those which the employer is liable to make in respect of the period.

Our recommended approach:

- enables Payment Summaries to be provided promptly;
- is consistent with one of the options for reporting contributions on payslips;
- avoids problems caused by variations in employer contributions from year to year due to timing differences (for example, if actual contributions in the year are used, then up to 15 months contributions may be reported in some years with only 9 months in the previous or following year).

3. *Consistency (refer to Part 3 of Appendix)*

Considerable confusion is caused due to the different definitions of income and fringe benefits for the various tests.

Recommendation

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.*

4. *Calculation of reportable employer superannuation contributions (refer to Part 4 of Appendix)*

We consider that the proposed method of determining the contributions to be included is totally inappropriate because:

- the calculation of the amount is far too complex, resulting in significant compliance costs for employers and a likely high error rate. Some examples are set out in Part 4 of the Appendix;
- the amounts to be reported are inconsistent with existing requirements to report contributions on payslips leading to duplication of reporting systems;

- high reporting error rates will result in an overload of work by the ATO and other Government agencies who will need to adjust previous tax assessments, co-contribution payments and other Government benefits as well as resulting in considerable taxpayer concern with these adjustments;
- the calculation method sends the wrong messages to employers and may lead to significant disadvantages for employees. Possible adverse outcomes include:
  - employers may cease contributing to superannuation for certain young workers, low paid workers and older workers;
  - employer contributions for employees who are salary sacrificing might be reduced;
  - employers may cease making regular monthly (or fortnightly) contributions and instead pay quarterly.

Recommendation

The Mercer simpler solution (refer Item 1 above) avoids or significantly reduces these problems and should be adopted instead.

Any other approach that is being considered should similarly be designed to avoid or minimise these problems.

We note that, due to the many complexities of the issues involved it may not be possible to fully solve all of the problems arising from this initiative.

5. Defined benefit employer contributions (refer to Part 5 of Appendix)

The Consultation Paper is unclear as to how employer contributions to fund defined benefits are to be treated and needs to be clarified.

Recommendation

We recommend that all employer contributions to fund defined benefits be excluded from the definition of reportable superannuation contributions.

This appears to be consistent with the draft Bill and our understanding of the intention of the Consultation Paper.

6. Defined benefit salary sacrifice contributions (refer to Part 6 of Appendix)

The Consultation Paper could be interpreted as indicating that employee contributions in respect of defined benefits which are paid on a salary sacrifice basis are to be included in reportable employer superannuation contributions. This appears to conflict with the draft Bill where such contributions seem to be excluded.

Recommendation

To avoid confusion, the treatment of such contributions should be clarified to make clear that such contributions do not need to be reported. Only additional "accumulation style" salary sacrifice contributions should be reported. As most defined benefit schemes are now closed to new members, the potential for any significant avoidance is very limited.

7. Self-employed (refer to Part 7 of Appendix)

Under the proposals set out in the draft Bill, self-employed persons will be unfairly treated as:

- it appears that, based on the wording of the draft Bill (which appears inconsistent with the Consultation Paper), contributions by the self-employed which are not claimed as a tax deduction will be double counted for some of the tests; and
- no account is taken of the fact that self-employed do not receive the benefit of employer SG contributions.

Recommendation

The treatment of contributions by the self-employed where a tax deduction is not claimed needs to be reassessed to avoid double counting of these contributions.

For equity reasons, deductible contributions of up to 9% of net business income should be excluded from reportable superannuation contributions.

The Mercer simpler solution can be adapted to take these issues into account.

Our more detailed comments and conclusions in relation to the above are set out in the Appendix. In Part 8 of the Appendix we have provided some brief comments on specific questions raised in the Consultation Paper.

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.

We would be happy to elaborate further on our comments. In particular, we would be very pleased to discuss the Mercer simpler solution with you. Please contact John Ward on (03) 9623 5552 or myself on (03) 9623 5464 to discuss these matters further.

Yours sincerely

Dr David Knox
Worldwide Partner

APPENDIX
COMMENTS ON "REFORMS TO INCOME TESTS"
CONSULTATION PAPER

Part 1: Mercer's simpler solution in respect of superannuation contributions

The system proposed in the Consultation Paper/ draft Bill will impose significant costs on employers as well as significant confusion. It is also likely to result in a high reporting error rate which will lead to the need for significant retrospective adjustments to tax assessments and other Government benefits which will lead to a drain on the resources of the ATO and other affected Government agencies.

We have set out more detail on these issues in Parts 4 to 7 of this Appendix.

The Mercer simpler solution involves a significant reduction in complexity for employers:

1. Employer would report **all** employer contributions for which the employer is liable in respect of the period (irrespective of whether they are to meet SG requirements or otherwise). (Contributions to fund defined benefits would be excluded.)

2. The ATO would estimate the SG contributions by calculating 9% of the individual's employment earnings from each employer (as shown on Payment Summaries).

The excess (if any) of the total contributions over the ATO's estimate of SG contributions would be the amount added to income for the purposes of the various income tests. (Refer below for additional comments in relation to defined benefits and self-employed persons.)

We expect that this could result in a marginally lower level of contributions being counted in the income tests than that which would apply under the Consultation Paper proposals.

This is because, under the Mercer simpler solution, the ATO estimate of SG contributions would include 9% of:

- payments for irregular overtime;
- payments for employees under age 18 who work less than 30 hours a week;
- payments for employees with salary and wages of less than $450 a month;
- payments for those over age 70.

However any such over-estimates are likely to be relatively small.

The ATO estimate will also include 9% of amounts in excess of the maximum contribution base (currently $38,180 a quarter). The impact of this over-estimate is likely to be negligible as, where income exceeds these levels, there is little likelihood of the individual benefiting from any Government program anyway. However, if desired, the ATO SG estimate could be limited to 9% of four times the maximum contribution base.

Such an approach would also enable employers to tie in their Payment Summary reporting with one of the existing options available to meet the requirements to report contributions on payslips (Regulation 19.13 of the Workplace Relations Regulations). The Workplace Relations Regulations provide an option of either reporting contributions which the employer is liable to pay in respect of the pay period or the contributions actually paid. Employers would be able to apply consistent reporting for payslips and Payment Summaries (by showing contributions which the employer is liable to pay on payslips).

The arguments in favour of our alternative solution compared to the proposals set out in the Consultation Paper can be summarised as follows:

1. Simpler for employers (refer to Part 4):
   - Consistent with one existing option available to meet requirements for reporting superannuation contributions on payslips
   - Employers would report on the same basis as the employer uses to actually pay superannuation contributions
   - Employers who decide to pay "SG" contributions for younger, older and low paid employees when not specifically required can continue to do so without incurring additional administrative costs
   - Employers who currently pay more frequently than quarterly can continue to do so without incurring additional administrative costs
   - Employers would not need to analyse industrial agreements and instruments to determine what needs to be reported

2. Achieves virtually all of the Government's aims whilst very significantly reducing the level of red-tape and administrative compliance costs for employers

3. Enables Payment Summaries to be issued within current time frames much more readily than under the Consultation Paper proposals (some transitional issues would still exist) (refer to Part 2)

4. Error rate in employer reporting will be significantly lower (refer to Part 4)

5. Staffing requirements for ATO and other Government agencies will be lower as a result of the lower error rate and less need for retrospective amendments to tax assessments and Government benefits (refer to Part 4)

On the other hand, the only apparent disadvantage is that there would be a slightly reduced impact on Government savings (refer to Part 4).

Recommendation

That the Mercer simpler solution be adopted in lieu of the proposals set out in the Consultation Paper.

Variation on our alternative solution

A variation of our alternative approach would be to take all employer (and tax deductible) contributions into account. This would be simpler but would result in a considerable reduction of entitlements for the vast majority of Australians unless the income thresholds for each income test are amended appropriately. Amendments to these thresholds would therefore be essential but would also be relatively straightforward.

For example, the current co-contribution thresholds are currently $30,342 and $60,342. If all employer contributions were to be included, then the upper thresholds should be increased to, say, $65,773 (= $60,342 + 9% x $60,342). For a taxpayer only receiving SG contributions, this revised upper threshold would mean that, approximately, there would be no change in the entitlement to a co-contribution. The lower threshold could be increased to $35,773 to maintain the current $30,000 band.

Self-employed

Any tax deductible contributions made by the self-employed or substantially self-employed would be added to any employer contributions for the purposes of the various income tests.

However, to provide greater equity, a deduction of 9% of their net business income would also be applied as a proxy for the SG contributions that would have been paid if the person had been employed. (Refer to Part 7 for further detail.)

Defined benefit members

Defined benefit funds present special problems. The nature of defined benefit arrangements makes it extremely difficult, if not impossible, for employers to report contributions paid to fund defined benefits.

The proposals set out in the Consultation Paper involved ignoring contributions to fund defined benefits. Based on the method proposed in the Consultation Paper, this was a reasonable approach which erred slightly in favour of defined benefit members.

Under the Mercer simpler solution, ignoring defined benefit contributions would result in an even more favourable outcome for defined benefit members.

However, few employers continue to provide defined benefits and most defined benefit arrangements are closed to new members. Regulations also prohibit the establishment of new defined benefit arrangements unless there at least 50 defined benefit members. Hence any opportunity for abuse is extremely limited.

Nevertheless, it would be possible to modify the Mercer simpler solution to take some account of defined benefit contributions.

One option would be to consider using notional concessional contributions. However this option is inappropriate for the following reasons:

- Not all defined benefit funds are required to calculate notional contributions;
- Notional contributions are generally reported each October, for the previous year. Due to the complexity of the calculations involved, superannuation funds would find it extremely difficult, if not impossible, to bring forward their reporting of such contributions. This would result in unacceptable delays for the ATO in completing tax assessments etc.; and
- Notional contributions are determined in accordance with Regulations which are difficult to interpret and include significant flaws. The calculations can result in significant inequities. As currently used, the inequities and confusion are only likely to impact on a very small proportion of defined benefit members (ie those where contributions are close to the concessional contribution caps of $50,000 or $100,000). If notional contributions were to be used for the purposes of the various income tests, then significant changes would need to be made to fix the problems in the current Regulations.

A preferable option would be as follows:

- The employer would indicate on the Payment Summary that an employee was entitled to defined benefits but no defined benefit contributions would be reported. (Where applicable, the employer would also indicate if defined benefit arrangements only applied for a part of the period covered by the Payment Summary);
- Defined benefit contributions would still be ignored;
- For a person entitled to defined benefits, rather than deducting 9% of the Payment Summary earnings from the employer contributions to determine the contributions to be taken into account for income test purposes, a deduction of only 3% of Payment Summary earnings would be deducted.

(In effect, this approach is equivalent to adding an allowance for defined benefit contributions of 6% of Payment Summary earnings to the contributions reported by employers and then deducting the full 9% allowance.)

An implicit allowance for defined benefit contributions at the 6% of Payment Summary earnings (rather than a higher percentage) can be justified by taking into account that:

- many defined benefit arrangements provide only part of the employee's SG benefits (for example, many funds provide a 3% accumulation benefit in addition to the defined benefit); and
- almost all defined benefit funds provide defined benefits related to a "superannuation salary" which is often considerably less than the earnings shown on Payment Summaries. Any additional benefits to meet the SG requirements on OTE are provided through accumulation arrangements (and hence these contributions would be included in the contributions reported by the employer.)

In view of the relatively small proportion of taxpayers who are entitled to defined benefits and the difficulties in establishing new arrangements, any opportunity for abuse is extremely limited. In any event, it is no more likely to result in abuse that the proposals set out in the Consultation Paper.

Whilst this approach may result in a slightly lower savings in Government revenue than the Consultation Paper approach, due to the small proportion of taxpayers entitled to defined benefits, the cost differentials are likely to be small.

Recommendation

If the Mercer simpler solution is adopted, consideration should be given to the adjusted approach as outlined above. The use of notional concessional contributions should, however, be avoided.

Part 2: Timing differences and payment summaries

The Consultation Paper and draft Bill are unclear as to whether contributions to be reported are:

- those actually paid in the income year; or
- those which the employer actually paid in respect of the income year; or
- those for which the employer is liable to pay in respect of the income year.

Irrespective of which of these interpretations is intended, we consider that the draft Bill contains significant flaws.

Contributions actually paid in the income year

If this approach is intended, then at least the following changes are necessary to the definition of reportable employer superannuation contributions in the draft Bill:

- Replacement of the words “for the income year” with “in the income year”;
- Rewriting part (d) of the definition. As it is currently written, any SG contributions paid during the year in respect of the June quarter could not be excluded as the employer would not have been liable to pay superannuation guarantee charge if the contributions had not been paid during the year. (The superannuation guarantee charge would only arise if the contributions were not paid by the following 28 July).

Such an approach will also potentially result in significant anomalies for individual taxpayers as employers may potentially pay more than 12 months contributions in some years and less in others. For example, in some years, up to 15 months contributions could be paid in the one income year with only 9 months contributions in the previous or following year. This could result in an individual’s ability to claim Government benefits such as Family Tax benefits, co-contributions etc varying significantly from year to year and in a manner totally outside the control of the individual.

Contributions actually paid in respect of the income year

This approach is strongly implied by the definition of reportable employer superannuation contributions (page 5 of draft Bill).

In particular, it is difficult to interpret the words “contributed for the person’s benefit, **for** the income year” in any other manner.

However, based on the draft wording, the contributions would only be reported if they had actually been made by the time they are reported.

Generally the employer contributions for the month of June (or the June quarter) would not be paid until July or later.

In other words, the contributions would often be made after Payment Summaries (on which the contributions are to be reported) have actually been issued.

This will lead to the following scenarios:

- many employers will need to issue a further Payment Summary including details of contributions paid for the income year which were paid after the original payment summary was issued; or
- these "late" contributions would be reported on the following year's Payment Summary potentially resulting in retrospective adjustments to Government co-contributions, Medicare levy surcharge payments, Family Tax Benefits and so on for a very large number of taxpayers.

However, reporting contributions paid in respect of the year is much fairer (than contributions paid in the year) in that it will always take into account 12 months contributions, and in particular, the contributions that are consistent with the individual taxpayer's salary and wages.

If this option is to be adopted, then it would be necessary to extend the timeframe for employers to provide Payment Summaries so that at least contributions paid in July for the previous income year could be included.

Contributions liable to be paid in respect of the income year

This approach avoids all of the problems above. There is no need for the employer to wait until the contributions are paid before providing a Payment Summary. The problem of varying periods of contributions being paid in different years is also avoided.

Part-year Payment Summaries

The proposed requirements require employers to provide a Payment Summary to a terminating employee within 14 days of request. Depending on which contributions need to be reported, it may be impossible for this requirement to be met without providing a second Payment Summary. This would not be an issue if employers need to report contributions that are liable to be paid in respect of the period.

Recommendation

*In order to avoid the various problems outlined above, we recommend that employers report contributions which they are **liable** to pay in respect of the income year. This should apply irrespective of whether the Mercer simpler solution or the Consultation Paper's model are adopted.*

Thus the contributions would be reported whether or not they had actually been paid by the time the Payment Summary is prepared.

This would minimise (or avoid):

- problems due to varying number of months contributions being counted for a particular income year; and
- the need to provide additional full-year Payment Summaries after the contributions have been paid as the amounts can be included on Payment Summaries before the contributions are actually paid; and
- retrospective adjustments to various Government benefits and taxes due to the amended or additional Payment Summaries.

Transitional arrangements

It is unlikely that all employers will be able to implement new procedures for preparing Payment Summaries in time to provide such Summaries to employees who terminate early in the 2009-10 year and request such a Summary. Special provisions will need to be included to either waive the requirement to provide such Summaries within 14 days of request or to enable employers to provide a second Payment Summary (potentially just showing the superannuation contributions) at a later date.

Part 3: Consistency

Considerable confusion is caused due to the different definitions of income and fringe benefits for the various tests.

It is unreasonable to expect that individual taxpayers will understand the subtle differences in the various tests.

The complexities involved in the multiple combination of tests also increases the need for financial and tax advice and the costs of obtaining it.

We also note that the Consultation Paper proposals are made considerably more complex due to the current variety of definitions included for the different income tests. For example, the Consultation Paper proposes that deductible contributions by the self-employed are to be added to those income tests which are currently based on taxable income but not for those tests which are currently based on assessable income (because the deductible contributions are already included in assessable income and they should not be added again).

If, however, taxable income was used as the base for all income tests, then deductible superannuation contributions could be added for all tests, hence considerably simplifying the system.

Recommendation

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.*

Part 4: Reportable Employer Superannuation Contributions

Superannuation Guarantee (SG) contributions

The Consultation Paper proposes that SG contributions are to be excluded from reportable employer superannuation contributions.

Excluding such contributions from the definition of reportable employer superannuation contributions is logical however the extraordinarily strict definition of what is an SG contribution will result in confusion and many complications for employers.

The approach taken in the Consultation Paper will mean that the following contributions are not considered to be excluded (as they are effectively covered by various exemptions from SG) and hence need to be included in reportable employer superannuation contributions:

- Contributions for employees whose salary and wages are less than $450 a month;
- Contributions for employees under age 18 who work less than 30 hours a week;
- Contributions for employees aged 70 or more;
- Contributions on earnings in excess of the maximum contribution base (currently $38,180 a quarter)
- Contributions on any remuneration item which are not OTE.

From an employer's perspective, the SG legislation is incredibly complex. Some of the more significant complexities revolve around the above exemptions.

Firstly, many employers consider that it is more equitable to pay superannuation for all employees rather than availing themselves of these exemptions.

Secondly, in our experience, many employers deliberately ignore these exemptions because they are too difficult to apply in practice and the potential penalties applying if the employer "gets it wrong" are too great. The employer is prepared to pay the contributions rather than implementing complex administrative procedures which would need to be continually monitored to determine when an exemption can be applied.

Examples of complexity

The $450 a month test

This test is based on salary and wages (not OTE). Few employers would understand the subtle differences between OTE and salary and wages.

It may not be known until the end of the month, whether the $450 has been reached. This makes it difficult to apply where employers contribute weekly or fortnightly.

Under 18 test

For those under age 18, there may be some weeks where less than 30 hours work is performed whilst, in other weeks, the 30 hours is exceeded.

Turning on and off the contributions is not a straightforward operation for many employers.

In some cases it is not even a simple matter to determine whether the employee has worked more than 30 hours, particularly if the work is casual and performed in different locations or parts of the employer's business.

Age 70 test

Superannuation Guarantee contributions only apply up to age 70. However many employers continue contributing for employees after age 70 as they wish to encourage rather than discourage older workers.

Maximum contribution base

Utilising the maximum contribution base is also difficult. For example, consider an employee with OTE of $15,000 a month. The employer could contribute a monthly amount of 9% of $12,727 (the monthly equivalent of the maximum contribution base).

However, this would not necessarily mean that the employer has met their SG requirements. For example, if the employee only works for two months in the quarter before resigning, the employee would not have reached the maximum contribution base for the quarter and the employer would need to make a top-up payment in respect of the earlier months.

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We expect that, if employers are required to determine contributions taking into account the above exemptions, just for the purpose of determining reportable employer superannuation contributions, some of the consequences may be as follows:

- Employers will incur considerable additional costs in performing the required calculations. These are costs that the employer has chosen to avoid, due to the high cost involved, preferring to pay more in superannuation contributions for employees;
- Employers, having been forced to work out that an exemption applies, will cease contributing where possible, potentially disadvantaging low paid, younger and older workers;
- Employers will cease weekly, fortnightly and monthly contributions and instead pay quarterly, as it is easier to apply the tests on a quarterly basis. This will disadvantage all employees as contributions will be invested later;
- Part-time employees under 18, will request their employer to cease contributing for them (adding further complexity for employers) where this may impact on, for example, their ability to claim ABSTUDY.

All of these consequences are undesirable. Rather than encouraging saving for retirement and instilling a savings culture at a younger age, the results will discourage retirement saving and, instead, instil an anti-savings culture.

Industrial agreements and instruments

The provisions to exclude other contributions required by an industrial agreement or industrial instrument add further complexity for employers. The result might be that contributions for some employees are reportable whereas a similar contribution for another employee would be a reportable contribution.

For example, a particular industrial agreement may require an employer to contribute certain contributions that are not specifically covered by the SG requirements. These would not be reportable for employees covered by that agreement. If the employer contributes on the same basis for all other employees, the relevant contributions for those other employees would be reportable.

In many cases, employers may need to obtain legal advice to clarify which contributions need to be treated as reportable contributions.

These requirements will lead to even more complicated procedures and systems and further increase the likelihood of reporting errors.

Impact of real salary sacrifice contributions

When an employee agrees to salary sacrifice, their future OTE reduces.

This enables employers to reduce the true employer contribution.

Example

Employee has OTE of $60,000. Employer pays SG contributions of $5,400 a year (i.e. 9% of $60,000).

Employee agrees to salary sacrifice $10,000 of earnings to superannuation. OTE reduces to $50,000. The employer now has 3 options:

1. Consider that the $10,000 salary sacrifice contribution satisfies the employer's SG requirements and effectively contribute zero;
2. Contribute 9% of the employee's reduced OTE ie reduce the employer contributions to $4,500; and
3. Continue contributing 9% of the unreduced OTE ie maintain contributions at $5,400

In a situation such as the above example, reasonable employers currently adopt the third option and maintain their contributions at the previous level.

We also note that Senator Sherry, the Minister for Superannuation and Corporate Law, has previously raised concerns about employers who reduce their contributions as a result of an employee electing to salary sacrifice and has flagged that the Government is considering changes in this area.

The Consultation Paper indicates that, in the above example, the "reasonable" employer would need to report $10,900 as reportable employer superannuation contributions. This includes the total of the real salary sacrifice contributions and the actual employer contributions less the reduced SG requirements of $4,500.

Requiring the employer to perform calculations on this basis is likely to encourage "reasonable" employers to reduce their contributions. This would be considered as unfair by employees and, presumably, the Minister for Superannuation and Corporate Law.

Further, it is not just in the area of salary sacrifice of superannuation contributions that this issue arises. In effect it would be an issue in relation to any remuneration packaging arrangement where there are some non-salary items which are not included in OTE (for example any fringe benefits).

We note that the Mercer simpler solution does not completely solve this “salary sacrifice” problem. However, it is less likely to result in the employer unfairly cutting back on contributions as it is not the employer that is required to ascertain and report contributions which were more than the specific requirements of the SG legislation.

This problem could be addressed by changes to the Superannuation Guarantee (Administration) Act to require employers to pay SG contributions in respect of amounts which are salary sacrificed. The Mercer simpler solution could then be adjusted by including allowance for such contributions in the ATO estimate of SG contributions.

Recommendation

The Mercer simpler solution (refer Item 1 above) avoids or significantly reduces these problems and should be adopted instead.

Any other approach that is being considered should similarly be designed to avoid or minimise these problems.

Part 5: Special issues for defined benefit members

We note that the Consultation Paper appears to propose that contributions to fund defined benefits would be ignored under the model proposed in the Consultation Paper.

We consider that this would be a sensible approach due to the complexities involved with defined benefit funds and the other proposals in the Consultation Paper.

However, the wording of the Consultation Paper has caused some people to consider whether this is actually the Government's intention. Hence, clarification is required.

In particular, the Consultation Paper indicates that employer contributions "that are less than or equal to an amount the employer must contribute in relation to a defined benefit interest of a person" are not to be included in the reportable contributions.

This raises the question as to what an employer "must" contribute. There is currently no minimum legislated contribution requirement. However, if an employer contributes less than that set out by the actuary in the fund's Funding and Solvency Certificate, certain consequences arise (including the need for a revised Certificate).

Due to its special purpose, the contributions requirements set out in a Funding and Solvency Certificate may not be adequate for the ongoing viability of the fund. The actuary may have recommended a higher level of contributions in an actuarial valuation or other advice. However, unless specified in the trust deed, there may be no legal requirement for the employer to contribute at these higher levels.

We expect that employers will, at best, have extreme difficulty in determining the contributions to report if any employer defined benefit contributions need to be reported at an individual employee level.

We consider it highly unlikely that employers sponsoring defined benefit funds are likely to "over-contribute" except for the purpose of establishing reasonable buffers to protect their fund from significant falls in investment markets (such has occurred in 2008).

Taking into account the difficulties in establishing new defined benefit funds (eg the 50 member minimum rule) we consider that all contributions to fund defined benefits should be excluded from the reporting requirements.

If the Government is still concerned that there are opportunities for abuse, we would be happy to discuss possible arrangements that could be implemented to protect against any such abuse.

Recommendation

Greater clarity needs to be provided to ensure that all contributions to fund defined benefits are not required to be reported.

Part 6: Defined benefit members salary sacrifice contributions

The Consultation Paper appears clear that voluntary member contributions paid by salary sacrifice will be reportable if they are paid to provide an accumulation interest in a defined benefit fund rather than a defined benefit interest. This appears reasonable.

However the treatment of voluntary member salary sacrifice contributions in respect of a defined benefit interest is unclear.

Members are normally required to make a contribution to fund part of their defined benefits. There are four common circumstances:

- The member contributions must be made from after tax income;
- The member contributions are automatically made by salary sacrifice;
- No member contributions are required but members are deemed to have made contributions;
- The member has an option to contribute from after tax income or on a salary sacrifice basis.

In some cases, more than one of the above approaches applies in the same fund for different employees of the same employer.

If the intention is that some or all of the above contributions are to be included, then employers are likely to face considerable confusion. Calculations will be further complicated in cases where the employer is on a contribution holiday (including salary sacrifice contributions).

Further, in many cases, trust deeds are unclear as to whether “member” contributions are actually salary sacrifice member contributions or are in fact employer contributions required by the Deed. We expect that many employers would need to seek legal advice as to whether the contributions are in fact reportable.

It would also be relatively simple for trust deeds to be amended to remove the requirement for members to contribute (but with a corresponding reduction in the salary package). This could be done in a manner which would not impact on the benefits provided, take home pay would be unaffected but contribution reporting would be avoided.

We note that including any of these contributions also appears to conflict with the draft Bill where such contributions seem to be excluded.

Recommendation

We recommend that all employer contributions to fund defined benefits be excluded from the definition of reportable superannuation contributions. This appears to be consistent with the draft Bill and our understanding of the intention of the Consultation Paper.

This would avoid confusion, provide greater simplification and would not lead to amendments (designed to avoid reporting such contributions) to current arrangements.

Part 7: Self-employed

It appears that, based on the proposed wording of the draft Bill, “undeducted” contributions for self-employed persons will be double counted for some of the tests. (“Undeducted” contributions are those for which the taxpayer does not claim a tax deduction.)

The definition of reportable superannuation contributions includes “the total amount of contributions made by the person that the person has deducted **or can deduct** under Subdivision 290-C for the income year”. This appears to mean that even if a self-employed person does not claim a tax deduction for some contributions (for example those in excess of the concessional contributions cap), these contributions will be included in reportable superannuation contributions.

As a result, where the income test is based on reportable superannuation contributions, these “undeducted” contributions will be double counted, (once as part of either taxable or assessable income, and again as part of reportable contributions). Tests affected include those in respect of the Medicare Levy Surcharge and Senior Australians’ Tax Offset.

Similar problems arise for those who meet the definition of substantially self-employed.

Further, we note that self-employed persons are generally not entitled to employer superannuation support. For employed persons, employer SG contributions are not included in reportable contributions. From an equity point of view, we consider that deductible contributions of up to 9% of net business income should not be included in reportable contributions.

We note that our alternative solution can readily accommodate such provisions.

Recommendation

If the Mercer simpler solution is not adopted, then:

- *the treatment of contributions by the self-employed where a tax deduction is not claimed needs to be reassessed to avoid double counting of these contributions; and*
- *for equity reasons, deductible contributions of up to 9% of net business income should be excluded from reportable superannuation contributions.*

The Mercer simpler solution can also readily allow for these recommendations.

Part 8: Comments on specific questions raised in the Consultation Paper

Paragraph 6 – particular superannuation contributions

We consider that a consistent definition of income should be applied to all income tests. Refer to Part 3 above.

Paragraph 12 – net financial investment losses

We consider that a consistent definition of income should be applied to all income tests. Refer to Part 3 above. As the treatment of net losses adds even more complexity, it would be preferable if this component was excluded from all income tests.

Paragraph 17 – adjusted fringe benefits

We consider that a consistent definition of income should be applied to all income tests. Refer to Part 3 above. The use of adjusted fringe benefits should be extended to all tests that currently use reportable fringe benefits.

Paragraph 35 – income for surcharge purposes

We consider that a consistent definition of income should be applied to all income tests. Refer to Part 3 above. As drafted, certain contributions for self-employed persons are inappropriately double counted. Refer to Part 8 above.

Paragraph 64 – employer superannuation contributions

The proposed definition is effectively unworkable and should be replaced with a simpler approach. Refer to Part 4 above.

Paragraph 74 – payment summary requirements

Refer to Part 2 above.