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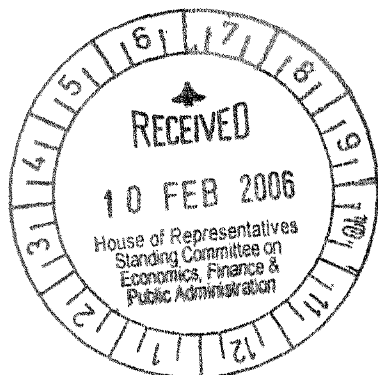

Australian
Administration
Services
a KAZ company

House of Representatives

Standing Committee on
Economics, Finance and Public Administration

Inquiry into
Improving the Superannuation Savings of People Under 40

Supplementary Submission
by Australian Administration Services Pty Ltd

10th February 2006

Australian Administration Services appreciated the opportunity to give evidence to the Committee with respect to this Inquiry on Friday 3rd February 2005.

We would like to make a supplementary submission to clarify and expand some issues which were raised by ourselves and other witnesses during the course of the public hearing on Friday.

1) Contributions Tax

(a) Why the contributions tax is egregious

The "contributions tax" paid by members of superannuation funds is in fact levied by the trustees of the fund to recoup the amount of income tax which the fund has paid for receiving taxable contributions in respect of that member.

Funds pay income tax on their 'income" - not only investment earnings but deductible contributions made by employers (including superannuation guarantee; any voluntary employer contributions and any salary sacrifice contributions), as well as contributions made by self-employed persons for whom a deduction is claimed. These are considered to be "taxable contributions" and to form part of the fund's "income" and, as such, are taxed accordingly.

Contributions to a superannuation fund are more accurately categorised in the hands of the fund trustees as capital, not as income. To use an analogy, the equivalent position with respect to bank accounts (if a flat rate income tax were levied directly on the banks themselves and not as part of individual tax returns) would be the banks having to pay the tax, not only on the interest earned on the accounts, but on the deposits made to them as well.

This has the effect of reducing the amount of a superannuation guarantee contribution from 9% to an effective rate of 7.65% - it is only this latter amount which is invested and returns earnings to the members' accounts.

Of course, an alternative to removing the contributions tax would be to increase the amount of superannuation guarantee contributions, thereby effectively transferring the cost from the government to employers, but this has obvious implications for business.

(b) Effect of removal on members' benefits – significant difference for under 40s

Removal of the contributions tax would benefit all members but, by virtue of the "magic of compounding interest", this measure would have the greatest effect on younger members with longer periods of future membership in the fund.

By way of illustration, utilising the ASIC calculator, the effect of removing the contributions tax can be demonstrated as follows: -

Age in years	Benefit at age 65 With Contributions Tax (Today's Dollars)	Benefit at Age 65 Without Contributions Tax (Today's Dollars)	Difference (Today's Dollars)
20	$438,000	$504,000	$66,000
30	$270,000	$312,000	$42,000
40	$154,000	$179,000	$25,000
50	$75,000	$88,000	$13,000
60	$20,000	$24,000	$4,000

This is based on the following assumptions, namely that: -

- the member has worked full-time without a break;
- they have zero superannuation accumulated (conts tax has no effect on balances);
- they have a gross annual salary of $50,000;
- only the 9% superannuation guarantee contributions are made; and
- they are not eligible for a co-contribution

while utilising ASIC's default assumptions with respect to earnings and fees.

It can be seen that, given their length of time within the superannuation system, by far the most significant improvement in benefits occurs for those under the age of 40.

The suggestion was made at the hearing on Friday that the removal of the contributions tax could be abused by high income earners salary sacrificing large proportions, or even all, of their income into superannuation, thereby avoiding paying income tax on those earnings at their marginal tax rate.

Not removing (or reducing) the contributions tax simply because a very small number of high income individuals may salary sacrifice what are considered to be excessive amounts, thereby denying the vast majority of the Australian people the benefit afforded by the reduction in the contributions tax, could well be considered to be "using a sledgehammer to crack a nut".

This is especially the case given that currently there exist two mechanisms designed to effectively limit the amount of superannuation which is subject to concessional tax treatment – the existence of age based deduction limits and the reasonable benefits limits.

(c) Existing mechanisms to prevent abuse (which could be modified)

(i) Deduction limits (currently age based)

A tax paying employer or a self-employed individual (provided they earn no more than ten percent of their income from employment) are entitled to claim a tax deduction in respect of contributions made to superannuation, in respect of eligible employees or themselves respectively, up to an amount determined in accordance with the age-based limits, as follows: -

Age in years	Deduction Limit (2005-06 financial year)
Under 35	$14,603
35 – 49	$40,560
50 and over	$100,587

Beyond these amounts no tax deduction can be claimed by the employer \ individual which means that the tax effectiveness of salary sacrifice contributions large amounts to superannuation is markedly reduced by these deduction limits.

(ii) Reasonable Benefit Limits

Reasonable benefit limits are the maximum amount of retirement and termination of employment benefits that a person can receive over their lifetime at concessional tax rates. The amount of any benefit paid in excess of the reasonable benefit limit is taxed at the taxpayer's marginal tax rate (plus Medicare levy).

The reasonable benefit limits for the 2005 \ 2006 financial year are as follows: -

Lump Sum	Pension (provided at least 50% taken as complying pension)
$648,946	$1,297,886

As both of these measures effectively serve to limit the amount of superannuation which receives the benefit of concessional taxation treatment, this would serve to mitigate the risk of "excessive" contributions being made to superannuation as a consequence of removing the 15% contributions tax.

(d) Possibility of amending deduction limits

If there is still concern about the possibility of excessive amounts being contributed by virtue of "salary sacrifice" arrangements into superannuation consideration could be given to amending the deduction limits as follows: -

- abolishing the age-based deduction limits and replacing with one deduction limit (say $70,000 - $80,000) indexed annually; or
- replacing the current flat dollar based limits with "percentage of total remuneration" limits, whereby an employer (or self-employed person) would only be able to contribute up to a certain proportion of "total remuneration" - salary plus all employer superannuation contributions (notional in the case of defined benefit) plus reportable fringe benefits for employees and "income" for the self-employed.

(e) Why it is difficult\impossible to base conts tax on age\income of members

At the Committee hearing on Friday the possibility was raised with respect to levying different rates of contribution tax depending on the member's age or income.

(i) How the "contributions tax" works

A superannuation fund pays tax on its income, including on taxable contributions, received by the fund during the financial year. This tax is generally paid by the fund with the return of its Business Activity Statements and is adjusted with the fund's filing of its tax return after the fund accounts for the financial year have been finalised and audited.

In determining the amount of income tax payable a fund can generally claim deductions for the expenses of running the fund as well as claim franking credits etc, which usually serves to reduce the effective rate of tax below 15%.

In order to recover the tax paid in respect of contribution "income" from members, fund trustees generally levy an amount against the members' benefits, usually 15% of the taxable contributions made in respect of that member. It is this amount, appearing on members' statements, which is commonly considered to be the "contributions tax" but in fact it is merely a levy made by the fund to recover the amount of tax it has paid with respect to the contributions received by that member.

(ii) Why it would be difficult to base conts tax on the age of the member

If the fund were to pay different rates of contributions tax based on the age of each member in respect of whom taxable contributions were made this would necessitate quarantining contributions made in respect of members of different age groups and their separate treatment in the accounts and tax return of the fund. This would result in a considerable amount of work for fund accountants, auditors and tax agents.

Furthermore, this is predicated on an assumption that superannuation funds have complete and accurate data as to their members' ages – this is not the case. In particular, employer-sponsored funds, where data generally is supplied by the employer and not the member themselves, have not always captured a date of birth; in some instances have utilised a "dummy date" and in other cases the data supplied by the employer is not accurate. Often this is not corrected until the member claims a benefit.

In addition, given the large volumes of data supplied by employers, on occasions contributions are allocated incorrectly to the wrong member. While these are generally corrected quickly, on occasions this correction occurs in the next financial year.

In every financial year where it is realised that one or more members were in a different age bracket, or where a contribution is re-allocated to the correct member (in a different age bracket) after year end, this would necessitate an amendment to the funds' tax position for each financial year affected. An amendment to the date of birth of even one member could require changes extending back over years, even decades (depending on the age brackets) – this would be exacerbated by the number of members involved. This is clearly an untenable position.

(iii)Why it would be impossible to base conts tax on income of members

Unlike ages, where in most instances the superannuation fund has data, if not always accurate or complete, a superannuation fund does not know the assessable income of its members. Accordingly, the fund determing the amount of "contributions tax" payable by virtue of the income of each member who has had a taxable contribution made in respect of them would be impossible.

2) Co-Contribution - how the co-contribution for low-income earners works

There appeared to be a suggestion at Friday's hearing that a low \ middle incomer earner needed to make a lump sum contribution of $1,000 (post tax income) to participate in the co-contributions scheme and that, accordingly, it should be re-configured to allow eligible contributions to be made as weekly deductions from pay as salary sacrifice.

This appears to refect a misunderstanding of the co-contributions scheme – it does not require a lump sum contribution but merely looks at the total amount of personal, undeducted (after tax) contributions made during a financial year.

The majority of employers will facilitate the remission of undeducted contributions directly from the employer to the superannuation fund today. For those few employees whose employer does not allow this, it is generally possible to contribute directly to the superannuation fund.

In addition, amending the necessary contribution from an undeducted (post tax) contribution to salary sacrifice (pre-tax, employer contribution) would not be feasible.

Frequently employers, and often superannuation funds themselves, do not make a distinction between superannuation guarantee contributions, additional employer contributions, and salary sacrifice contributions. This distinction is not one recognised within the superannuation and taxation systems themselves – they are all (potentially) deductible, taxable, employer contributions - the distinction is only relevant at the employer level with respect to the employer's obligations under the superannuation guarantee legislation and any employment agreement in place with the employee (re additional and salary sacrifice).

In addition, there seems to be a misapprehension that the employee needs to complete cumbersome paperwork in order to "apply" for the contribution. This is not the case – the co-contribution is administered automatically by the Australian Taxation Office ("ATO") as part of the annual tax return and assessment process.

By combining the annual Member Contribution Statement ("MCS") provided by each fund to the ATO by 31st October each year (containing the amounts of employer, taxable contributions and undeducted, post-tax contributions, made in respect of each member of the fund) with each individual's tax return the ATO is able to determine eligibility for, and quantum of, any co-contribution. The ATO then remits the amount of the co-contribution directly to the fund.

Accordingly, the member does not even need to indicate on their tax return whether they have made any undeducted contributions – this is done on their behalf by the superannuation fund itself.

3) **Early release of benefits to purchase house**

The suggestion was made repeatedly at Friday's hearing that consideration should be given to the early release of superannuation monies to facilitate the purchase of a home.

While this may appear to be attractive, we would like to make the following observations: -

- concessional tax treatment is afforded to superannuation to further Retirement Income Principles – given the projected increase in the age \ dependency ration, and considerations of inter-generational equity, the desired policy outcome is to maximise, within reason, an individual's income in retirement in order to minimise their reliance on the age pension;
- early release of superannuation monies, subject to the limited exception outlined below, does nothing to improve income in retirement - in fact it has a negative effect;
- while home ownership does make a marked difference in quality of life in retirement, as there is no need to pay rent, the proposal to allow early release should only be supported if it were established that this would make the difference between being able to purchase a house and never being able to do so in a person's lifetime;
- we would submit that, instead of making the difference between home ownership and non home ownership, in the vast majority of cases all that the early release of superannuation monies would facilitate would be the acquisition of a more expensive property or the purchase occurring earlier than it might otherwise have done;
- if, as has been suggested, only undeducted contributions are released then the only difference releasing superannuation monies would make, as opposed to saving for a deposit outside superannuation, would be the amount generated by the difference between the effective tax rate of superannuation (approx 15%) and the individual's marginal tax rate. For low income individuals this could be negligible, and indeed even negative;
- it should be noted that, whilst they are perhaps not the most financially desirable product, loans are now available with respect to 100% of the value of the property, and in some cases including the expenses of purchase. The major deterrent to the acquisition of a home is frequently the size of mortgage and the level of income necessitated to service it;
- it should be noted that one of the existing grounds for early release is, at the discretion of APRA, release on compassionate grounds, one basis for which is the imminent foreclosure of a mortgage. In other words, a member of a superannuation fund today should not be in a position where they have superannuation funds but lose their house – APRA is able to permit the trustee to release an amount of the member's superannuation benefit in these circumstances;
- any limitations imposed on the quantum of superannuation which is allowed to be withdrawn (eg 50%) are observed by the trustee of the fund to which the application is made and, as such, are able to be avoided by transferring the remaining benefit to another fund, where the limitation would be imposed again. In order to avoid this outcome it would be necessary for information with respect to amounts contributed and withdrawn to be transferred from fund to fund, which represents an additional administrative import on superannuation funds; and
- finally, consideration should be given to the macro-economic effect of releasing superannuation monies to purchase a home and whether, analogous to the first home-buyers' scheme, this may have the unintended consequence of increasing house prices further.

Accordingly, we submit that the early release of superannuation funds to allow the purchase of a home is detrimental to retirement income principles of maximising individual's income in retirement and, accordingly, should not be considered.

4) Consolidation of members' accounts, member benefit protection lost superannuation

(a) Consolidation

Comments were made at the hearing on Friday with respect to consolidating members' accounts and the positive effect this may have on the superannuation benefits of the under 40s.

Two suggestions were made: -

- that perhaps changes needed to be made to facilitate this, and
- accounts could be eroded through fees and charges.

With respect to the first point above, three points should be noted: -

- many industry funds, some years ago, developed a "transfer protocol" whereby members could authorise their fund to act as an agent on their behalf to apply for benefits in other funds;
- this mechanism has been formalised by the ATO into the scheme know as "Supermatch"; and
- portability regulations were gazetted in 2003 to facilitate transfers between funds, however, there are difficulties with the interpretation of one aspect of these regulations which are outlined below.

(i) Existence of Portability Regulations

The *Superannuation Industry (Supervision) Regulations 1994* ("SIS") provide for superannuation benefits to be portable between superannuation funds at the request of the member.

To quote from the *Explanatory Statement to Statutory Rules No 251 of 2003:* -

> *"That is, there will be a requirement on superannuation funds to transfer a member's benefits to another fund if requested by the member".*
>
> *"This regulation provides that the new requirements that a fund must roll over or transfer a member's benefits on request applies to both regulated superannuation funds and approved deposit funds".*
>
> *"The trustee may refuse to roll over ... an amount if the amount is only part of the member's benefit and the roll over ... would result in the member's residual interest ... being less than $5,000. This will allow funds to require a minimum balance to remain in the fund ... in the case of part transfers. However, a member would still be able to move their entire balance (a full transfer) if they so desired".*

The *Explanatory Statement to Select Legislative Instrument 2005 No. 142* states as follows: -

> *"The Government considers that individuals should have the right to determine who manages their superannuation and should be free to move their benefits when they choose without unnecessary restrictions".*
>
> *"The purpose of the Regulations is to remove the restriction that provides that compulsory portability does not apply ... in relation to a member where the fund has received an employer contribution ... for the benefit of the member in the past six months".*
>
> *"Portability has been in place since 1 July 2004 and allows members to consolidate their superannuation benefits in one account, thus avoiding multiple sets of fees and charges, and allowing individuals to decide on the superannuation fund to manage such benefits".*

Accordingy, it is open to a member of a fund to transfer their benefits from one fund to another to consolidate their superannuation. Consideration could be given to an education campaign to advise members about their rights to transfer benefits, together with information about exit fees.

(ii) Exit \ Termination \ Withdrawal Fees

It should be noted that that while most some superannuation funds levy some kind of exit fee, generally of the order of $50 - $100, to cover the costs of paying the benefit, in some funds the withdrawal fee is much more substantive and is in fact an early termination fee. The portability regulations do not override these fees, so members who chose to exercise their right transfer their benefit from such a fund would still be liable for this fee.

(iii)Practical issue with full portability when contributions continuing

Having to transfer a member's entire benefit, in circumstances where employer contributions will continue to be made, creates a number of practical, administrative difficulties.

Normally, when a member's benefit is paid, their account is closed. In circumstances where a subsequent employer contribution is received for that member, this will necessitate a new account being set-up for that member with a different member \ account number.

In addition, the payment of the entire benefit and the closure of the member's account will generally result in the discontinuation of insurance cover for that member which might otherwise have continued had the account not been closed.

(iv)Difficulties with the interpretation \ application of the portability regs

There continues to be a great deal of confusion within the superannuation industry with respect to the application of one aspect of the portability regulations.

Paragraph 6.35(1)(b) states that a trustee may refuse to roll over or transfer an amount: -

> *"if the amount to be rolled over ... is part only of the member's interest in the fund, and the effect of rolling over ... the amount would be that the member's interest in the fund from which the amount is to be rolled over ...would be less than $5 000".*

Given the practical \ administrative difficulties outlined above, there are three different potential interpretations of paragraph 6.35(1)(b) in circumstances where employer contributions are continuing to be made. The issue is whether, in circumstances where the trustee has received a request to transfer a member's entire account balance, whether: -

(a) the trustee should consider the request to transfer the benefit to be a request for a full transfer, in which case the entire amount must be transferred; or

(b) the trustee is able to consider it to be a request for a partial transfer, in which case the trustee is entitled to retain $5,000 within the member's account in the fund.

These different interpretations, together with an extract from the portability regulations and some analysis, are outlined in the appendix.

(v) Need for clarity in the portability regulations

These difficulties with the interpretation and application of the portability regulations in circumstances where contributions are likely to continue are creating a great deal of confusion in the industry and this is preventing this benefit from being clearly communicated to members. Accordingly, it would be of great benefit if the regulations could be amended to clarify their intended application.

(b) Existence of Member Benefit Protection Regulations

With respect to erosion through fees, it is important to note that there are "member protection" regulations which generally prevent a fund, in respect of account balances under $1,000, from deducting any more in fees than is credited in earnings, thereby preventing benefits under $1,000 from "going backwards". Benefits above this amount are generally self-sustaining i.e. they earn sufficient amounts to cover fees.

(c) Lost superannuation

There are two factors which contribute to the amount of "lost" superannuation reported to the ATO: -

- the definition of "lost member"; and
- the fact that, even if the member cannot contact the member, because the member may have forgotten to advise of a change of address, this does not necessarily mean that the member is not aware that they have money in that fund.

There is a fundamental difficulty with the definition of "lost member". Under the SIS regulations a member is considered to be lost if **either** of the following circumstances is met: -

- the member is uncontactable; **or**
- the member is an **inactive** member.

A member is defined as being an **inactive** member if: -

- they have been a member of the fund for longer than 2 years;
- they joined the fund as an employer-sponsored member; and
- the fund has not received a contribution or rollover in respect of them within the last two years of their membership of the fund.

Given the long-term nature of superannuation; the frequency with which people change jobs and that, under choice, contributions may be directed to a different fund, a two-year period of inactivity is far too short. By way of contrast, the period of inactivity for every-day, operating, transactional bank accounts to be declared "lost" is generally six or seven years.

By legislating such a relatively short period of time the number of members reported as lost, who in fact may be well aware of where their superannuation is located, is augmented. Accordingly, we submit that consideration should be given to increasing the inactivity period from two to a more realistic seven years.

Should you have any queries with respect to this, please do not hesitate to contact the writer.

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APPENDIX

1) Three alternative constructions of paragraph 6.35(1)(b) of the portability regulations

(A) Most conservative construction

The most conservative interpretation is that a request to transfer member's benefit must always be implemented as a full portability transfer.

(B) First alternative construction

One argument is that if a trustee knows, as a question of fact, that employer contributions will continue to be made then a portability claim can be considered to be a partial transfer. Accordingly, if the member indicates that employer contributions will continue then the trustee is entitled to treat as a partial transfer.

Arguably, however, while this may afford the trustee the right to ask the question as to whether employer contributions will continue to be made into the fund, if the member either: -

- responds in the negative; or
- fails to respond at all

then this necessitates the request being treated as a full portability claim.

(C) Second alternative construction

The alternate argument is based on the contention that a member with a zero account balance still has an "interest" in the fund.

On this basis, it is argued that an application to transfer the account balance could be construed as an application to transfer either the: -

- entire "account balance"; or
- entire "interest"

and, as such, that there is a distinction to be drawn between a request to transfer the entire "account balance" and the entire "interest". The argument is that, while a request to transfer the entire "interest" must be honoured as a request for full portability, if a request is received to transfer the entire "account balance" the trustee is entitled to treat the request as a request for a partial transfer, not a full transfer.

If this interpretation is taken to its logical conclusion then a member requesting a transfer of their full account balance, even when no further employer contributions are to be made, can never be considered to be effecting a full portability transfer but can only ever be considered to be effecting a partial transfer. This appears to defeat the intention and purpose of the regulations in respect of full transfers.

The Explanatory Statement to the original 2003 Regulations, explaining the exemption under paragraph 6.35(1)(b), states as follows: -

> *"The trustee may refuse a request to roll over ... an amount if the trustee has rolled over ... an amount of the member's interest under [Portability] Regulation[s] in the past 12 months. This will allow funds to develop rules so that regular contributions to a fund are not required to be transferred or rolled over every time they are made (e.g. every fortnight) avoiding the high administrative costs that may otherwise arise. Funds will still be able to allow more regular ... rollovers if they so wish".*

This would appear to demonstrate that, but for the creation of the "12 month" exemption, the effect of the regulations was intended to be that even "regular contributions ... [would have been] required to be transferred ... every time they are made (eg every fortnight)". This reflects an intention that a request for

a transfer of the whole of the member's withdrawal benefit would have been given effect to were it not for the exemption created under paragraph 6.35(1)(b) specifically to prevent this from occurring.

This clearly indicates the intention that a request to transfer the whole amount of the member's withdrawal benefit should be considered to be a full portability claim. It also argues against the contention that the receipt of future contributions is relevant in this context – it indicates that a request for a full transfer must be honoured irrespective of future contributions.

2) Portability Regulations

Sub-regulation 6.33(1) of SIS states as follows: -

> ***"REG 6.33 Request for rollover or transfer of withdrawal benefit***
> *(1) A member of a regulated superannuation fund or an approved deposit fund may, in writing, ask the trustee of the fund to roll over or transfer* ***an amount*** *that is the* ***whole or part*** *of the member's withdrawal benefit"* ***(emphasis added).***

The regulation clearly refers to a request to roll over an "amount" which is the whole of the member's withdrawal benefit. In other words - what is intended here is that the member can ask for the whole of their withdrawal benefit to be transferred.

Sub-reg 6.34(1) of SIS - the operative provision - states as follows: -

> ***"REG 6.34 Rollover or transfer of withdrawal benefit***
> *(1) Subject to regulations 6.35 and 6.38, if a trustee of a regulated superannuation fund or an approved deposit fund receives a request under regulation 6.33, the trustee* ***must roll over or transfer the amount*** *in accordance with the request"* ***(emphasis added).***

Again - the reference here is to an "amount" – not an interest. It is clearly contemplated that, if a member asks for the whole of their withdrawal benefit to be rolled-over under sub-reg 6.33(1) then, under sub-reg 6.34(1), the trustee must transfer that amount - the whole of the member's withdrawal benefit.

Similarly - sub-reg 6.34(2) and sub-reg 6.34(3) also refer to the "trustee ... roll[ing] over ... **the amount**" and "[t]he trustee must roll over ... **the amount**" respectively – no reference to "interest".

Paragraph 6.35(1)(b) states as follows: -

> ***"REG 6.35 When a trustee may refuse to roll over or transfer an amount***
> *"(1) A trustee may refuse to roll over or transfer an amount under regulation 6.34 if:*
> *(a) ..... ; or*
> *(b) the amount to be rolled over or transferred is part only of the member's interest in the fund, and the effect of rolling over or transferring the amount would be that the member's interest in the fund from which the amount is to be rolled over or transferred would be less than $5 000".*

Here the exception refers to "**the amount** ... [being] part only of the member's interest ... and the effect of rolling over ... **the amount** would be that the member's interest ... would be less than $5 000". The "interest" here is clearly one which can be quantified - the member's withdrawal benefit - as it refers to "the [remaining] member's interest being less than $5000". In other words - this clearly contemplates that the member's interest is their (quantifiable) withdrawal benefit and not any contingent (non quantifiable) interest, potential entitlement or mere expectation.