

# MERCER

Human Resource Consulting

Mercer Human Resource Consulting Pty Ltd  
ABN 32 005 315 917  
33 Exhibition Street Melbourne Vic 3000  
GPO Box 9946 Melbourne Vic 3001  
03 9623 5555 Fax 03 8640 0800  
[www.mercerHR.com.au](http://www.mercerHR.com.au)

15 January 2007

Committee Secretary  
Senate Economics Committee  
Department of the Senate  
PO Box 6100  
Parliament House  
CANBERRA ACT 2600

Subject:

INQUIRY INTO THE PROVISIONS OF THE TAX LAWS AMENDMENT (SIMPLIFIED SUPERANNUATION) BILL 2006

Dear Secretary

Mercer is pleased to respond to the Committee's request for submissions on the Tax Laws Amendment (Simplified Superannuation) Bill 2006.

The Committee may be aware that Mercer has been very active on the Government's proposals since they were first announced in May last year. We provided eight detailed submissions during the consultation process and have also been active in providing feedback to Treasury officials on draft legislation through confidential industry working parties.

We would like to acknowledge the tremendous effort made by Treasury to get the Bill to its current stage in the time available and the willingness which Treasury and its staff have shown to work with the industry in this development phase. It is clear that this has been a mammoth task.

We also note at the outset that we strongly support the overall thrust of the proposed changes. This has represented our public position since May 2006. However we do have some serious concerns about some aspects of the Bill and the actual operations of the package. There are also a number of minor issues which need to be reconsidered.

The comments in our submission are therefore provided with the aim of improving the efficiency and outcomes arising from the package.

Page 2

15 January 2007

Committee Secretary

Senate Economics Committee

## **Executive Summary**

Our major concerns are as follows:

*No-TFN issues:* The workability of the proposed system is dependent on an extremely high level of TFN provision. More needs to be done to achieve this outcome including provision of matched TFNs by the ATO to superannuation funds and a requirement for employers to provide TFNs for existing employees as at say 1 May 2007.

The proposed approach of making superannuation funds liable for no-TFN tax is also cumbersome and should be replaced by a withholding tax system in which the member and not the fund is liable for reclaiming any tax paid.

It is also important that any requirement to refuse to accept non-concessional contributions be either removed or at least deferred until a much higher level of TFN provision has been obtained. Such deferral should not end until at least 31 December 2007. This would still give funds time to refund (before 30 June 2008) any such concessional contributions already received from members who have still not provided their TFN.

*Tax on superannuation death benefits:* The proposed tax adds considerable complexity to the system and can result in numerous anomalies. In many cases this tax can be avoided assuming the member receives appropriate advice. We therefore recommend that tax on death benefits be removed (at least where the benefit is paid to a dependant who meets the definition of dependant for SIS purposes which would include adult children).

*Invalidity benefits:* Further clarification is required on the invalidity process, method of calculation and definitions.

*Employment Termination Payments:* Two issues particularly need to be addressed -

- anomalies in the tax of death benefits (where significantly different tax can apply depending on whether benefits are paid through the employee's estate or directly to beneficiaries);
- anomalies in the tax payable if benefits are rolled over during the transitional period.

# MERCER

Human Resource Consulting

Page 3

15 January 2007

Committee Secretary

Senate Economics Committee

*Employer issues:* Tax deductibility of contributions made during the 2007 calendar year by employers with substituted accounting periods needs to be urgently clarified. In addition, the loss of tax deductibility for certain contributions if they are made shortly after an employee has left service needs to be reviewed to provide greater clarity and fairness.

*Additional complexity:* We are concerned that the proportional draw down requirements of the Bill enable regulations to be issued that may require some superannuation interests to be combined and others separated for the purposes of determining the tax components of the drawn down amount. Depending on (and if) such regulations are issued, this could have significant administration implications.

The proposed different treatment of crystallising the pre-July 1983 component for untaxed elements in public sector schemes is a concern and needs to be reconsidered. We recommend that the pre-July 1983 component be crystallised as at 1 July 2007 for all funds.

*Other Issues:* We have also commented on a number of other more minor issues.

*Timing:* The significant changes to administration systems required by the package will place considerable strain on superannuation funds and their service providers.

We have suggested that some of the issues which we consider are less important (but potentially extremely time consuming and costly) could be removed or deferred.

- The proposed new portability requirements should be deferred;
- The requirement for individual funds to refund non-concessional contributions in excess of \$450,000 pa should be removed, or at the very least deferred.
- The requirement to refuse to accept non-concessional contributions by members who have not supplied a TFN should also be deferred until a much greater level of TFN disclosure has been obtained.

Regulators will also need to adopt a lenient approach as funds will struggle to comply with the volume of change and the extremely short implementation time frame.

# MERCER

Human Resource Consulting

Page 4

15 January 2007

Committee Secretary

Senate Economics Committee

We would be happy to discuss the contents of our submission and to answer any questions at the Committee's public hearings. Please contact either John Ward (03 9623 5552) or Dr David Knox (03 9623 5464) to arrange for us to appear or if you have any queries on our submission. Our detailed comments are set out in the Appendix.

Yours Sincerely

A handwritten signature in black ink, appearing to be 'Peter Promnitz', written in a cursive style.

Peter Promnitz  
Chief Executive Officer

Page 5

15 January 2007

Committee Secretary

Senate Economics Committee

## **APPENDIX: COMMENTS ON THE TAX LAWS AMENDMENT (SIMPLIFIED SUPERANNUATION) BILL 2006**

### **No -TFN**

If a fund does not have a member's TFN, then the following issues arise:

- The fund will not be allowed to accept any non-concessional contributions (eg member contributions from after-tax income). This is not in the Bill but is expected to be included in the Regulations;
- The fund will become liable for an additional "No-TFN tax" on any concessional contributions made in respect of the member;
- Subject to time restrictions, if the member subsequently provides a TFN, the fund may obtain a tax offset to recoup the no-TFN tax paid.

The no-TFN provisions are our most significant concerns on the workability of the new system for the following reasons:

- As at 1 July 2007, there are likely to be a very significant number of members who have not supplied their TFN. For some funds, it is currently more than half the membership;
- Identifying and either refusing to accept or refunding non-concessional contributions will be a costly administrative challenge. Amendments to administration systems will need to be in place from 1 July 2007. The volume of the administrative task of returning non-concessional contributions also has the potential to significantly undermine the ability of superannuation funds to properly administer funds in the months following the introduction of the new system;
- New systems will also need to be in place by 1 July 2007 to deduct the no-TFN tax when any benefits are paid. Whilst the tax does not have to be paid until at least 30 June 2008, funds will need to ensure that the appropriate amount has been withheld from the benefit of any exiting member;
- The process for recovering any no-TFN tax is cumbersome and slow;
- It is likely that many members will never recoup the no-TFN tax paid.

Page 6

15 January 2007

Committee Secretary

Senate Economics Committee

Clearly there is a need to increase the level of TFN provision. However, this will just reduce the problem rather than eliminate it. We believe that the recoupment process also needs to be changed and the requirements to refuse to accept non-concessional contributions without a TFN needs to be modified.

The significant consequences of a fund not having many members' TFNs threaten to reduce the community's strong confidence in the superannuation system. We therefore recommend that serious consideration be given to the following recommendations so that all Australians are encouraged to increase their superannuation savings.

### *Obtaining tax file numbers*

For some large funds, more than 50% of members have not supplied a TFN. For many funds it is over 20%. There are several reasons for this:

- General inertia;
- The current legislation and lack of consistency between Regulators, in particular, APRA and the ATO. Whilst the Tax File Number Declaration Form issued by the ATO provides employees with an opportunity to tick a box advising their employer to pass on their TFN to their superannuation fund, this form does not meet the TFN disclosure guidelines issued by APRA. This has resulted in some funds refusing to accept TFNs provided in this manner and some employers refusing to pass them on;
- The old surcharge legislation where there were advantages for high income earners if they did not disclose their TFN;
- In a relatively small number of cases the member may not have a TFN. This could be because:
  - the member has only recently joined the workforce (a TFN will generally be obtained after a few weeks);
  - the member is not employed or has limited or no taxable income (eg a non-working spouse);
  - the member has never worked in Australia but may be employed overseas by an Australian company.

# MERCER

Human Resource Consulting

Page 7

15 January 2007

Committee Secretary

Senate Economics Committee

We understand that the proposed changes to legislation and the Tax File Declaration Form will mean that employers will be required to pass on the employee's TFN (if known). However this will only apply to cases where an employee completes the updated TFN declaration form. Presumably APRA will also amend its TFN Guidelines to conform to the new TFN Declaration Form. These proposed changes are likely to increase significantly the provision of TFNs for *new* employees but are unlikely to affect the significant number of *current* employees who have not supplied a TFN to their fund.

The biggest problem to overcome will be the general inertia. It is likely that most superannuation funds have already written to members (more than once) over the last few years in an attempt to obtain TFNs but with limited success. Many members do not read material from their fund or just do not get around to providing their TFN. Further letters from trustees may elicit some more TFNs. Letters from the ATO to members will also help. However, based on past experience, such an approach is likely to have limited success. Likewise, we expect that media advertising will have only a limited impact.

However, the new system will rely on there being an extremely high level of TFN provision. If this does not occur, the strain on superannuation funds will be extreme and benefits for a significant proportion of members will be reduced due to the no-TFN tax, which, we expect, will in many cases never be recouped.

In order to have any significant impact on the provision of TFNs, further changes are essential.

We believe that the following suggestions will be more successful in increasing the level of TFN provision:

1. The ATO should provide superannuation funds with the TFN details of members for whom the ATO considers there has been an appropriate matching. We understand that this could reduce the number of missing TFNs significantly;
2. Employers should be required to pass on an employee's TFN where that is known (even if the employee has not completed the revised TFN Declaration Form). If the employer can utilise the TFN for the purpose of calculating the PAYG requirements on the employee's cash remuneration, it is difficult to understand why that TFN cannot be used for the purposes of determining tax on the superannuation component of the employee's remuneration. This could be a once only requirement for employees as at, say, 1 May 2007. (Note that this date

Page 8

15 January 2007

Committee Secretary

Senate Economics Committee

needs to be earlier than 1 July 2007 to enable funds to collect and process the TFNs before the start of the new system). If required, employees could be given an option to “opt out” of this provision.

A combination of these approaches should result in a much higher collection of TFNs, thereby maintaining the community’s confidence in superannuation and reducing some of the problems outlined below.

### *No-TFN process*

As indicated above, the proposed process also needs to be reviewed.

The requirement that non-concessional contributions cannot be accepted without a TFN will, in practice, be very difficult to achieve. Some of the problems include:

- In many cases, contributions are received in bulk from say, an employer, and accepted by the fund before allocation to individual members. It is only at the point of allocation that it will be determined that a TFN has not been provided;
- In some cases, eg contributions for the self-employed or transfers from overseas funds, whether the contribution is a non-concessional or concessional contribution may not be known for some months after the contribution is received.

Further, the rules of some defined benefit funds include provisions for a compulsory member contribution. If these contributions are not made (or cannot be accepted), the defined benefits will need to be adjusted and in some cases the member will forfeit any rights to defined benefits in future and insurance cover may be placed at risk.

In order to prevent a huge administrative task for funds to reject such non-concessional contributions, we believe that the requirement to reject such contributions should be removed or at least deferred until the new system settles down and a high level of TFN provision has been reached. We recommend a six month moratorium in which contributions could still be accepted. If a TFN has not been provided by the end of that period, the fund would then be required to refund the non-concessional contributions. Such a moratorium would still enable the contribution caps to apply effectively in the 2007-2008 financial year.



Page 9

15 January 2007

Committee Secretary

Senate Economics Committee

Secondly, we are concerned that the liability for the no-TFN tax should be a liability of the superannuation fund. We question why a fund should be liable for this tax when the fund has no control over whether the TFN is provided or not. It is the responsibility of the member to provide the TFN. It should therefore be the member who is liable for the tax. The fund's responsibility should be merely to withhold an appropriate amount of tax where required and remit this to the ATO.

Placing the tax liability on the member with the fund only being responsible for withholding the tax is also consistent with the treatment of employment earnings and other interest income where the employer and bank etc withholds the tax which remains a liability of the individual.

Such an approach would also solve several other significant problems with the no-TFN system proposed in the Bill.

Some of the problems include:

- There will be a considerable delay in recouping any no-TFN tax paid. The proposed process involves the fund claiming a tax offset in its next tax return. In effect this is likely to mean that the relevant tax offset may not be received until 12 months or more after the member supplies their TFN;
- In many cases, the member may have left the fund before the TFN is provided adding further to the administrative difficulties in reclaiming the tax. Even if the TFN is provided when the individual is still a member, due to the long delay in reclaiming the tax, membership may have ceased by the time the refund is received. In such cases it will not be possible for the fund to accept the refund (the individual would need to reapply for membership first);
- Even if these membership rules were changed, the fund would then incur considerable cost in tracking the former member and arranging for the refund to be passed on. These costs will normally be borne by all other members as member protection rules will generally mean that costs cannot be passed on to the former member;
- Where a fund is wound up, it will no longer be possible for members to reclaim any no-TFN tax as the fund will no longer be in existence to make the claim;

Page 10

15 January 2007

Committee Secretary

Senate Economics Committee

- Determining interest on tax offset – the Bill indicates that interest will be payable where the employer should have passed on the TFN. It is unclear who will be required to make an assessment of whether or not the employer should have passed on the TFN and how this will be achieved – particularly for current members.

The most significant of these problems would be solved if the no-TFN tax is imposed on the member and not the fund. Under such a system, the fund would withhold the tax and then provide the member with a form indicating the tax withheld. The member could then sign the form, add their TFN, the name of the fund they want the refund paid to and send the form to the ATO. The form would also include an authorisation by the member for the ATO to forward the TFN to the superannuation fund. The refund would be obtained more quickly and would be sent to a fund in which the member still had an interest.

We note that the Bill only requires funds to deduct and remit the no-TFN tax no earlier than 30 June 2008. Whilst this provides funds with some leeway, it should be noted that funds will still need to have systems in place by 1 July 2007 to enable the withholding of tax from members who are leaving the fund during 2007-2008. It is therefore critical that any solutions acknowledge that TFNs need to be provided before 1 July 2007.

### *Summary*

In our view the no-TFN issues are extremely serious and have the potential of turning the introduction of the new system into a significant problem for funds, many members and the community's perception of superannuation. However we recognise the fundamental importance of contribution caps in the new system and the requirement to use TFNs. The issues need to be confronted now and a more appropriate solution developed.

Page 11

15 January 2007

Committee Secretary

Senate Economics Committee

We therefore recommend that, to solve the no-TFN problems:

- The ATO pass on to superannuation funds any TFNs which it has already matched;
- Employers be required to provide TFNs to superannuation funds for all employees as at, say 1 May 2007;
- New TFN Declaration Forms be developed, and APRA guidelines be revised so that they are consistent with the new forms, to require employers to pass on TFNs for new employees;
- The no-TFN tax should become a liability of the member rather than the fund with the fund withholding any necessary tax and advising the member. The member should be responsible for reclaiming the tax;
- Requirements to reject non-concessional contributions for a member who has not supplied a TFN should be removed or at least deferred until a higher level of TFN provision has occurred.

Page 12

15 January 2007

Committee Secretary

Senate Economics Committee

## Superannuation death benefits

One aspect of the superannuation system that has not been simplified to any significant degree is the tax on death benefits. In fact the taxes applicable on death benefits are even more complex than envisaged in the Government's announcements in May and September 2006.

The complexity involved in death benefits can best be illustrated by some examples.

### Example 1

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

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

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

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

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

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

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

Page 13

15 January 2007

Committee Secretary

Senate Economics Committee

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

#### Example 2

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

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

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

Page 14

15 January 2007

Committee Secretary

Senate Economics Committee

### Example 3

Members F and G are similar to member A in example 1. However in each case the trustee decides to provide the member's spouse with a reversionary pension rather than a lump sum. Because the member was over age 60 at death, the death benefit pensions will not be subject to tax.

Shortly afterwards each spouse decides to take the remaining value of their pension in cash.

Member F's spouse is over age 60 and there is no tax on the benefit.

Member G's spouse is not yet age 60. If the cashing is treated as a commutation and the commutation occurs more than 6 months after the date of death and 3 months after grant of probate, tax of 15% (ie about \$60,000) applies to the commuted value.

On the other hand, if the spouse had merely elected to take the balance of the account as a pension payment, no tax would have applied.

(The Bill does not clarify whether such payments will be treated as commutations or pension payments.)

Example 3 highlights that there are significant pitfalls that can result in significant additional tax unless appropriate financial advice is obtained.

# MERCER

Human Resource Consulting

Page 15

15 January 2007

Committee Secretary

Senate Economics Committee

## Example 4

Members H and I are aged 35 and have been working with the same employer for 10 years. Both have been members of their employer's default fund and have an account balance of \$40,000 and an insured death benefit of \$50,000 giving a total death benefit of \$90,000. Neither member has any dependants when they are killed in a car accident.

Member I recently transferred her account balance to another fund under the portability regulations but has retained her insurance cover and ongoing contributions in the default fund.

Because the default fund has been claiming a tax deduction for insurance premiums, only a proportion of the benefit is considered to be an element taxed in the fund. This proportion is calculated as the period of relevant service divided by the total period to age 65 ( $10/40 = 25\%$ ). The balance is an element untaxed in the fund.

The tax position on death is as follows:

### Member H:

25% of the benefit is considered to be an element taxed in the fund and is taxed at 15% (Tax =  $.25 \times \$90,000 \times 15\% = \$3,375$ );

75% of the benefit is considered to be an element untaxed in the fund and is taxed at 30% (Tax =  $.75 \times \$90,000 \times 30\% = \$20,250$ )

Total tax is \$23,625

### Member I:

25% of the benefit in the default fund is considered to be an element taxed in the fund and is taxed at 15% (Tax =  $.25 \times \$50,000 \times 15\% = \$1,875$ );

75% of the benefit in the default fund is considered to be an element untaxed in the fund and is taxed at 30% (Tax =  $.75 \times \$50,000 \times 30\% = \$11,250$ )

100% of the benefit in the rollover fund is considered to be an element taxed in the fund (because there has been no insurance) and is taxed at 15% (Tax =  $\$40,000 \times 15\% = \$6,000$ )

Total tax is \$19,125

Example 4 not only highlights that the tax on death benefits is not as simple as implied by the Government's earlier announcements where only a 15% tax was mentioned, but that significant differences in tax can occur depending on specific circumstances.

# MERCER

Human Resource Consulting

Page 16

15 January 2007

Committee Secretary

Senate Economics Committee

## *Summary*

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

We believe strongly that lump sum death benefits should be tax free. As a minimum, death benefits payable to any dependants as defined for the purposes of the SIS legislation should be tax free. (The SIS definition includes all children of the deceased irrespective of age.)



Page 17

15 January 2007

Committee Secretary

Senate Economics Committee

## **Invalidity benefits**

The current tax provisions include anomalies and ambiguities and we had hoped that these would be clarified. However this does not seem to be the case.

Under current law, where a member satisfies the requirements, a post-June 1994 invalidity component is only generated when a benefit is paid in cash or is rolled over to another fund. The invalidity component is calculated as a proportion of the benefit paid or rolled over and is then crystallised at that amount.

However, if a disabled member decides to leave their benefit in their current fund, the invalidity component is not generated until it is eventually paid. This difference results in much confusion. It is also unclear how the invalidity component should be calculated at some future date, particularly where other benefits have been rolled into the fund since the invalidity occurred.

Rather than clarifying the position, the Bill appears to increase the confusion.

The proposed Section 307-225 requires trustees to crystallise an invalidity component as at 1 July 2007 for those disabled members who have left their benefit in the fund. This requirement appears totally clear. However it is directly contradicted by paragraph 2.111 of the Explanatory Memorandum.

This inconsistency between the Bill and EM needs to be clarified.

The Bill also includes new provisions enabling benefits to be rolled over within the same fund. It is possible that these provisions will enable trustees to roll-over a disablement benefit within the same fund and that this will result in the immediate generation of an invalidity component in the same way that would apply if the benefit had been rolled over to another fund.

The intention needs to be clarified.

We also have some concerns regarding some changes in wording which may adversely impact disabled members.

Page 18

15 January 2007

Committee Secretary

Senate Economics Committee

## *Wording Issues*

In some cases, even though there appears to be no intention to change current practice, “modernisation” of the wording may lead to an adverse impact on members.

Our particular concerns are set out below:

- The definition of “last retirement day” in Section 995-1(1). This date is used to determine invalidity components. The new definition states that this day means “if an individual’s employment or office would have terminated when he or she reached a particular age or completed a particular period of service – the day he or she would reach that age or complete the period of service .....”. This implies that, for a member on a fixed term contract, that the last retirement day would be the day the contract expires (even though the contract may be renewed). This differs from the related existing definition which is similar but which requires that termination of employment will *necessarily occur* on reaching the age or completing the period of service. As most contracts could be renewed, the current wording would generally result in the member’s 65<sup>th</sup> birthday being used as a default (except in special cases, eg airline pilots, where it may be a requirement for an employee to retire at an earlier age). If the meaning of this definition has changed, it will result in a reduction in the amount of invalidity components and increase the tax on benefits due to ill-health.
- The changed wording in relation to when an invalidity component may arise could be interpreted in a manner that would result in disabled members who leave their benefit in the fund for a period after becoming disabled never being able to claim their invalidity component. As indicated earlier in this submission, current tax law is not clear. Funds are relying on a tax ruling which was produced following a Court case – however, the wording on which the Court case was determined and on which the subsequent tax ruling was based has been replaced and may no longer be relevant.

Page 19

15 January 2007

Committee Secretary

Senate Economics Committee

## Employment Termination Payments

The Bill makes significant changes to the taxation of payments by employers on termination of employment. These changes are, in the main, consistent with the Government's announcements. Where only one such payment is received, the process is relatively straightforward however it can become more complex where a person receives more than one such payment.

However there are two particular areas with which we are concerned.

### *Treatment of death benefits*

Significantly different tax consequences can arise depending on how the benefit is paid – in particular whether it is paid through the member's estate or directly to the member's spouse or children. The following example illustrates this:

#### Example 5

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

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

Of the death benefit, \$400,000 will be paid to dependants. The first \$140,000 of this will be tax free and 45% tax will apply to the balance (ie tax of \$117,000).

\$600,000 will be paid to non-dependants and tax of 30% will apply to the first \$140,000 of this and tax of 45% on the balance (ie tax of \$249,000).

The total tax payable by the estate will therefore be \$366,000.

If the employer had paid \$200,000 to each of these beneficiaries directly, rather than to the estate, each of the two dependants would have been liable for tax of \$27,000 (no tax on the first \$140,000 and 15% on the balance), and the three non-dependants would have been liable for tax of \$69,000 (30% tax on the first \$140,000 and 45% on the balance). The total tax payable would have been \$261,000.

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

Page 20

15 January 2007

Committee Secretary

Senate Economics Committee

In this example, by paying the benefit to the employee's estate rather than directly to the beneficiaries, the total tax on the benefit has risen from \$261,000 to \$366,000. We consider that this outcome is unreasonable. Many employers would feel responsible to ensure that the benefit is paid tax effectively and such major discrepancies are therefore likely to require employers to incur additional costs to ensure that the payments made are made in an effective manner.

We recommend that the tax treatment of amounts paid to the estate be amended so that they more accurately reflect the tax treatment which would apply if the payments were made directly.

### *Transitional Provisions*

Transitional provisions apply to employment termination payments paid in respect of an existing agreement up to 30 June 2012. These provisions are more complex and become even more so if there is more than one such payment.

However we have three main concerns:

- The transitional payments do not apply where the payment is made following the death of the employee – we see no reason why such payments should be excluded from the transitional tax arrangements;
- The rollover provisions are not only very complex but can lead to inequitable results. The example below illustrates the problem; and
- The transitional provisions may be insufficient to convince some senior executives not to retire before July 2007. By retiring before 1 July 2007, they can take advantage of the more favourable current rules.

Page 21

15 January 2007

Committee Secretary

Senate Economics Committee

## Example 6

Employee A retires on 1 July 2008 after 40 years service. He is entitled to an employment termination payment of \$2 million. The payment meets the requirements for use of the transitional provisions. He considers four options:

### **Option 1: Take the whole benefit as cash**

In this case, 15/40ths (ie \$750,000) of his benefit will be considered to be pre-July 1983 and not subject to tax. The balance of the benefit will be taxed as follows:

- first \$140,000 will be taxed at 15% = \$21,000
- the next \$860,000 will be taxed at 30% = \$258,000
- the balance of \$250,000 will be taxed at 45% = \$112,500

The total tax payable will therefore be **\$391,500**.

### **Option 2: roll-over the whole benefit into superannuation**

In this case, 25/40ths of the benefit will be considered to be an untaxed element and subject to 15% contribution tax ( $.15 \times \$1,250,000 = \$187,500$ )

The whole excess over a concessional amount of \$1 million is considered to be a concessional contribution and the excess over the employee's concessional contributions cap of \$100,000 will be subject to the excess contributions tax of 31.5% ( $.315 \times \$900,000 = \$283,500$  assuming that there are no other concessional contributions in the year).

The excess contributions are also added to the members non-concessional contributions for the year and any excess over the non-concessional cap (generally \$450,000) is taxed at a further 46.5% ( $.465 \times \$450,000 = \$209,250$  assuming that there are no other non-concessional contributions made in the year).

The total tax payable will therefore be **\$680,250**.

If the member had already used up part or all of his contribution limits, additional tax of up to \$287,250 could apply bringing the total tax on the ETP to **\$967,500**.

Example 6 continued on next page

Page 22

15 January 2007

Committee Secretary

Senate Economics Committee

Example 6 continued

**Option 3: roll-over half the benefit and take the balance as a second payment in cash**

In this case, 25/40ths of the amount rolled over will be considered to be an untaxed element and subject to 15% contribution tax ( $.15 \times \$625,000 = \$93,750$ ).

No further tax will apply to the amount rolled over as it does not exceed \$1 million and there have been no other Employment Termination Payments.

For the amount paid in cash, 15/40ths (\$375,000) will be considered to be a pre-July 1983 component and therefore not subject to tax.

The balance of the benefit will be taxed as follows:

- first \$140,000 will be taxed at 15% = \$21,000
- the next \$185,000 will be taxed at 30% = \$55,500
- the balance of \$300,000 will be taxed at 45% = \$135,000

The total tax payable will therefore be **\$305,250**.

**Option 4: take half the benefit in cash and roll-over the balance to superannuation**

In this case, 15/40ths (ie \$375,000) of his benefit will be considered to be pre-July 1983 and not subject to tax.

The balance of the cash benefit will be taxed as follows:

- first \$140,000 will be taxed at 15% = \$21,000
- the next \$485,000 will be taxed at 30% = \$145,500

Of the amount rolled over, 25/40ths will be considered to be an untaxed element and subject to 15% contribution tax ( $.15 \times \$625,000 = \$93,750$ ).

Because half of the benefit (\$1 million) has already been paid in cash the whole amount rolled over will be considered to be a concessional contribution and the excess over the employee's concessional contributions cap of \$100,000 will be subject to the excess contributions tax of 31.5% ( $.315 \times \$900,000 = \$283,500$  assuming that there are no other concessional contributions in the year).

The excess contributions are also added to the members non-concessional contributions for the year and any excess over the non-concessional cap (generally \$450,000) is taxed at a further 46.5% ( $.465 \times \$450,000 = \$209,250$  assuming that there are no other non-concessional contributions made in the year).

The total tax payable will therefore be **\$753,000**. If the member had already used up part or all of his contribution limits, additional tax of up to \$287,250 could apply bringing the total tax on the ETP to **\$1,040,250**.

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

# MERCER

Human Resource Consulting

Page 23

15 January 2007

Committee Secretary

Senate Economics Committee

The above example shows that the amount of tax payable on a transitional ETP can vary considerably depending on whether it is rolled over or taken as cash. Even more importantly, the order in which the payments to the roll-over fund and the member is critical with, in the above example, a potential difference in tax of up to \$735,000 depending on whether the half of the benefit which is rolled over is rolled over before or after the other half of the benefit is paid in cash.

It is also worth noting that, if the employee retires before 1 July 2007 and rolls-over a similar \$2 million payment, the total tax payable would have been only \$187,500, considerably less than any of the post June 2007 alternatives. For higher payments, the tax savings resulting from retiring before 1 July 2007 will be even greater. The attractiveness of the pre-July 2007 provisions could lead to decisions by senior executives to retire before 1 July 2007. Where a number of key employees of a company decide to retire, this could place considerable strain on the company.

Page 24

15 January 2007

Committee Secretary

Senate Economics Committee

## **Employer Issues**

### *Tax deductibility for employers with a Substituted Accounting Period*

The Bill will remove the current age based limits from the commencement of the employer's 2007-2008 year. For employers with substituted accounting periods, the effective date will not be 1 July 2007.

For an employer with a 2007-2008 year commencing before 1 July 2007 the Bill implies that the deductible limits will effectively be removed before 1 July 2007. This may be as early as 1 January 2007 in some cases. However there has been no clear statement from the Government that this is the case. Employers whose 2007-2008 year commences on 1 January 2007 are therefore still unclear as to what contributions will be tax deductible – even though the year has already started.

The Government needs to announce its intentions immediately.

For late balancing employers, the provisions of the Bill will mean that from 1 July 2007, there will be a period where the employer continues to have age based limits applying whilst the member is also subject to the new contribution caps. This will add confusion in the short term and would also appear inequitable.

It is recommended that the age based deductible limits be removed entirely from 1 July 2007.

### *Tax Deductibility for employers*

It appears that the tax deductibility rules for employer contributions may have been tightened. In particular we are concerned with the lack of tax deductibility for voluntary employer (and some salary sacrifice) contributions made after an employee terminates employment.

Sections 290-60 and 290-85 of the Bill limit tax deductibility of contributions for former employees except where the contribution is required to satisfy Superannuation Guarantee requirements or is a one-off salary sacrifice contribution.



Page 25

15 January 2007

Committee Secretary

Senate Economics Committee

These requirements mean that employers who make regular voluntary contributions will be unable to claim a tax deduction for those voluntary contributions made shortly after an employee leaves. Employers may also be unable to claim a deduction for some salary sacrifice contributions.

#### Example 7

An employer has agreed to pay contributions of 12% rather than the required SG contribution of 9% for its employees. This may or may not have been formalised in a workplace agreement or other employment agreements. The employer also allows employees to contribute additional amounts by salary sacrifice. Contributions are normally forwarded to the relevant superannuation funds two weeks after each fortnightly pay day.

An employee leaves service at short notice (or dies) and two employer contributions will be made after the termination of employment – one for the previous pay period and another for the current pay period.

The employer will be able to claim a tax deduction for the normal SG contribution. The employer will also be able to claim a tax deduction for the salary sacrifice contribution included in the first contribution but not the second. It would not be able to claim a deduction for the 3% voluntary contribution included in either the first or second payment.

This example illustrates how the tax deductibility treatment can be unfair. These provisions may:

- discourage employers from making voluntary contributions;
- discourage employers from allowing salary sacrifice contributions;
- encourage employers to delay passing salary sacrifice amounts to a superannuation fund so that there is sufficient time to ensure that all salary sacrifice amounts can be incorporated in only one contribution payment made after termination of employment.

We consider that all of these employer responses are inconsistent with the Government's intention to encourage superannuation. It is clearly impossible for an employer to always make these contributions before termination of employment. We recommend that deductibility be extended to all contributions in respect of a member's period of employment, irrespective of whether they are made before or after employment terminates. If an unlimited period is not possible, we would be happy to discuss the imposition of specified limits.

Page 26

15 January 2007

Committee Secretary

Senate Economics Committee

## **Additional Complexity**

### *Proportional draw downs*

As announced by the Government, members will be required to draw down their various tax components in proportion to their total benefit. This results in simplification of the system from the member's point of view although it also removes an option for the member to minimise the tax payable.

Our concern is not with the concept of the proportional draw down requirement but with potential problems that may arise in the Regulations which have not yet been released. In particular, the Bill enables the issuing of Regulations which can require that a fund treat:

- more than one interest as a single interest; or
- a single interest as more than one interest.

(The concept of what constitutes an "interest" is not always clear. An obvious example is where a member may have a defined benefit interest in a fund as well as an additional accumulation interest. Similarly a member may have a pension interest and a lump sum interest. In these cases, the contributions being used to fund each interest may be specified separately. In other cases, a member may have two accumulation interests in a fund because the fund has separated contributions made in respect of the current period of employment from any amounts that have been rolled over into the fund. Or a member may have created two allocated pension interests by rolling over different amounts to purchase two allocated pensions in the same fund.)

Until the Regulations are available it is not possible to comment effectively. However we are concerned that the administrative difficulties of meeting any such requirements may be very high as combining or separating interests may be incompatible with the way the funds' benefits are currently configured on the administration system.

Page 27

15 January 2007

Committee Secretary

Senate Economics Committee

## *Public Sector Schemes*

The tax treatment of benefits payable from a public sector scheme which pays some benefits as untaxed elements is considerably different to the tax treatment of benefits from other funds. We have previously argued that this is inappropriate and a more consistent approach should be adopted. However we accept that the Government is committed to the approach set out in the Bill

One aspect which did however surprise us was an aspect that has not previously been announced. That is the crystallisation of the pre-July 1983 component as at 1 July 2007. We had assumed that this would apply to all funds. However the Bill indicates that the pre-July 1983 component will not be crystallised at that date in respect of any element untaxed in the fund. We cannot understand the logic of this aspect and it would appear to result in many anomalies and difficulties for those funds. We can envisage situations where some members may lose all entitlement to a pre-July 1983 component (where a fund changes its policy and begins paying benefits in taxed form). Conversely, it appears that where a benefit that has previously been considered to be taxed (with a crystallised pre-July 1983 component), is later paid in untaxed form, then a further pre-July 1983 component is determined resulting in an overstatement of the pre-July 1983 component.

We therefore recommend that pre-July 1983 components are crystallised as at 1 July 2007 for members of untaxed schemes as well as for members of taxed schemes.

Page 28

15 January 2007

Committee Secretary

Senate Economics Committee

## **Other Issues**

### *Adverse changes*

There are some cases where the Bill changes the current rules in a manner which results in adverse tax outcomes for members even though there has been no Government announcement of such changes. Some examples are:

- Currently a tax free threshold applies to benefits received from age 55. The Bill changes the age from which the threshold applies from age 55 to preservation age which will eventually become age 60 and will eventually result in some simplification as all benefits will be tax free from that age. For most members this change in the threshold age will have no effect as most members will be unable to access any benefits before preservation age. It should however be acknowledged that it will adversely affect those who access their benefit due to invalidity or because of financial hardship or compassionate grounds;
- Funds are currently able to claim a tax deduction in certain cases provided that they have augmented a member's death benefit by an amount which approximately reflects the contribution tax that has been deducted over past years from the member's account. The provisions of the Bill change the eligibility conditions for this deduction and it will no longer be available if the benefit is paid to a member's dependant who is not a spouse, former spouse or child. This will mean that funds will no longer be able to augment benefits in such cases resulting in lower benefits to beneficiaries;
- It would appear that it will no longer be possible for a member to split non-concessional contributions with their spouse. (Concessional contributions can continue to be split.) This could create some concern from members who are making non-concessional contributions in the current year on the understanding that it will be possible to split them immediately after 30 June 2007. With some limited exceptions, contributions can only be split following the end of the year. Under the new system it appears that it will not be possible to split non-concessional contributions even if they were made before 1 July 2007.

Page 29

15 January 2007

Committee Secretary

Senate Economics Committee

### *Interest on excess contributions tax*

Hopefully there will be few cases of members making excess contributions arising. However the addition of interest to any additional excess contributions tax is likely to create considerable concern from members. Interest commences to accrue 21 days after the tax assessment is issued (Section 292-G). However, there is unlikely to be time for a member to receive their assessment, pass it on to the fund and for the fund to process the payment within the 21 day period before interest starts accruing.

Either the interest period needs to be extended or the ATO needs to waive the addition of interest where the tax is paid within a reasonable period.

### *Transfers of benefits from overseas funds*

Including amounts transferred from overseas funds as part of the non-concessional contributions cap will mean that some Australians will be unable to effectively consolidate their retirement savings as large amounts which accrued overseas will need to be kept outside Australia.

This would seem to create difficulties for those affected and would also appear to be against the interest of Australia. Surely it would be preferable for such overseas benefits to be transferred to Australia. Any amounts transferred would be subject to preservation requirements.

We again recommend that amounts transferred from bona fide overseas funds (in respect of overseas employment) be excluded from counting as non-concessional contributions.

Page 30

15 January 2007

Committee Secretary

Senate Economics Committee

## **Timing issues**

We are very concerned that the commencement of the new system is now less than six months away. Superannuation funds need to make very major changes to administration systems in a very short period of time.

Yet, whilst many of the new requirements are included in the current Bill, many other requirements are still not known as they will be included in consequential bills, amendments to the current Bill or in Regulations.

It is therefore going to be extremely difficult for the industry and individual funds to be fully ready by 1 July 2007. Despite this concern, we do not believe that the new system should be deferred.

However we do believe that there are some aspects of the new system which could be deferred to enable funds to cope more adequately in the short term (some of these requirements are not included in the current Bill but are expected to be included in Regulations). Aspects which could be deferred include:

- Portability – the proposed reduction in the maximum transfer period from 90 to 30 days. We expect that in the months immediately following 1 July 2007, many funds will have difficulty in processing benefit payments and roll-overs as they install new systems, ensure that these systems are working correctly and that benefits and tax under the new system have been appropriately calculated. Normal time frames for making such payments will be extended and in some cases may exceed 30 days. The change to the portability requirements should therefore be deferred until funds have been able to properly install their new systems. A six month deferral to 31 December 2007 would appear appropriate at this time;
- The requirement for funds to refuse to accept excess non-concessional contributions in excess of \$450,000 (members under age 65) and \$150,000 (members over age 65). Whilst it may sound simple, the introduction of administrative mechanisms to determine whether the limit has been exceeded will be time-consuming – time which needs to be devoted to what we consider are more urgent parts of the package. In any event, members could circumvent this requirement by splitting contributions between more than one fund. Under the provisions of the Bill, the ATO will also need to determine the total of undeducted contributions made by an individual to all funds and then require any excess contributions to be refunded. It

# MERCER

Human Resource Consulting

Page 31

15 January 2007

Committee Secretary

Senate Economics Committee

therefore appears unnecessary that superannuation funds also be required to partly monitor, during the year, contributions that it receives. We recommend that this requirement be removed totally. If this is not possible, it should be deferred until at least 31 December 2007. In either case, it would not affect the integrity of the new system;

- The requirement to refuse to accept non-concessional contributions where no TFN has been provided. Until the level of no-TFN provision has been reduced substantially, this requirement could totally consume fund administrators. Again, this requirement could be deferred to 31 December 2007 with any non-concessional contributions received prior to that date being refunded if a TFN has not been supplied by that date. Such a deferral would not affect the effective introduction of the non-concessional contributions cap in the 2007-2008 year.

The ATO and other regulators should also adopt a lenient policy in regard to penalising breaches of the new requirements including reporting time frames etc.