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## Chapter 6

### Other Adequacy Issues

#### Introduction

6.1 During the inquiry, a number of other arrangements were identified which could also impact on the adequacy of individuals' or groups' retirement incomes. These include:

- arrangements for the self-employed;
- member protection arrangements; and
- the \$450 Superannuation Guarantee (SG) earnings threshold.

6.2 The arrangements for people with broken working patterns are also discussed.

#### The self-employed

##### *Current treatment of self-employed persons*

6.3 The SG scheme applies to all employers in respect of their full-time, part-time and casual employees, with only limited exemptions. The definitions of 'employee' and 'employer' are quite broad under the SG legislation, and include for instance members of a company board or its directors, and can also include persons working under contracts, depending on their circumstances. There is no legislative provision however to require self-employed persons to make superannuation contributions on their own behalf on a regular or systematic basis. Often, it is considered the proceeds of the sale of a business by a small owner-operator will be used by that individual to fund their retirement.

6.4 There are two main tax concessions currently available to self-employed or 'substantially self-employed' persons to encourage them to make contributions to superannuation on their own behalf (or for the benefit of their dependants) while working, or when exiting a business.

6.5 The concessions available for the self-employed are as follows:

- A full tax deduction on a specified amount of contributions, as well as a partial deduction (75 per cent) for an additional amount of contributions up to the individual age-based maximum deductible contribution (MDC) limit.
  - The amount which is fully deductible was raised from \$3,000 to \$5,000 per annum effective from 1 July 2002.
- An exemption from income tax and capital gains tax where a small business owner uses the proceeds from the sale of their business for the purposes of retirement. In these circumstances, the monies are considered in effect to be an

‘eligible termination payment’ (ETP). Eligibility requirements apply to this tax concession and there is a lifetime retirement exemption limit of \$500,000 for any individual.

- The retirement exemption applies to disposals on or after 1 July 1997.<sup>1</sup>

6.6 Once their moneys are placed within a superannuation fund or equivalent, the same taxation arrangements apply for the self-employed as for employed persons on withdrawal of their monies.

6.7 A ‘substantially self-employed’ person may also qualify for the concessions even though they have received a small amount of employer superannuation support in any one financial year. Eligibility requirements, pertaining to the portion of income derived from employment falling below a certain threshold during the year (the 10 per cent rule), must however be met for this to occur.

6.8 Superannuation coverage amongst self-employed persons is much lower than for employed persons. ASFA has reported for instance that nearly 65 per cent of owner managers of unincorporated enterprises have either no superannuation or are currently not making contributions.<sup>2</sup>

### ***Options for change***

6.9 Of the views put to the Committee on this issue, most supported additional measures to further encourage savings by the self-employed. Recommendations ranged from options to ensure the tax treatment of superannuation contributions by the self-employed are brought into line with the tax concessions currently provided for employees, to provision for indexation of the tax free threshold for superannuation contributions by the self-employed.<sup>3</sup> The issue of compulsion for contributions by the self-employed was also raised and supported by various witnesses and submissions to the inquiry.<sup>4</sup>

6.10 Supporters of change to the current arrangements to align the treatment of the self-employed with that of employed persons argued that the current tax treatment for the self-employed is significantly less favourable. Superannuation contributions made by employers on behalf of employees are fully tax deductible up to age-based limits. In contrast, for the self-employed, only a relatively low portion of contributions is fully deductible, with the remainder generally qualifying for a 75 per cent deduction.

6.11 For example, in its written submission, ASFA argued that the arrangements for the self-employed should be brought into line with those which apply to employed persons. ASFA submitted that, in its view, there was no reason to continue to discriminate against a particular group in the labour force in this way, although fiscal

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1 *Submission 78*, Treasury, p. 12.

2 *Submission 73*, ASFA, p. 61.

3 See for example *Submissions 43*, CPA, p. 7.

4 See for example *Submission 73*, ASFA, p 61. See also *Submission 31*, ICAA, p. 3.

implications may have provided the original rationale for the different treatment of the two groups. Up until recently, the threshold which was fully tax deductible for the self-employed had not been adjusted over time (there is no provision to index this amount).<sup>5</sup>

6.12 Further, ASFA suggested it was necessary to increase the incentives for the self-employed to make contributions to superannuation so as to raise the level of superannuation coverage for this group. This would be done by making contributions fully deductible for the self-employed, up to the limits that apply to employees. In the longer term, ASFA also suggested it may be appropriate to give consideration to possible mechanisms for compelling superannuation contributions by the self-employed and/or providing greater tax incentives (beyond tax deductibility for voluntary contributions).<sup>6</sup>

6.13 CPA also supported removing the existing limit to the amount of monies which are fully tax deductible for the self-employed, up to the taxpayers' aged-based deduction limit. CPA indicated:

This measure would ensure that self-employed workers are given the same advantages as employers.<sup>7</sup>

6.14 In addition, as a longer term measure, CPA recommended consideration be given to reforming the current age-based deduction limits, in order to better reflect Australia's changing working and lifestyle patterns. This issue is discussed in more detail at Part III – Equity. The issue of breaking the current employment nexus with superannuation was also canvassed by the CPA.

6.15 In its submission, Supermaster recommended the self-employed be compulsorily required to make contributions equivalent to rates required under the SG, with some qualifications:

Phase in a requirement for all income earners not receiving at least 9% employer support to personally contribute at the same rate.

Probably a minimum age of say 40 and minimum income level should apply. Tax deductibility should be at a flat 30%, identical with the company tax rate.<sup>8</sup>

6.16 Mr Lorimer from the Small Independent Superannuation Funds Association Ltd (SISFA) also recommended a compulsory system of superannuation for the self-employed:

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5 *Submission 73*, ASFA, p. 61.

6 *Submission 73*, ASFA, p. 62.

7 *Submission 43*, CPA, p. 7.

8 *Submission 40*, Supermaster, p.11

We would take a similar position for self-employed people. In other words, we would encourage a compulsory system of superannuation at the employee and self-employed levels.<sup>9</sup>

6.17 Mr Hopley from the Institute of Company Directors similarly advocated the introduction of compulsion for self-employed people to contribute to superannuation:

We believe there is a lack of equity at the moment in that self-employed people are not required to make super guarantee contributions on their own behalf.<sup>10</sup>

6.18 Mr Hopley also provided details on how a compulsory system of contributions for the self-employed might work. He recommended a phased introduction of compulsory contributions, but noted there would be some difficulties:

The difficulty I see is enforcement and the timing issue with regard to the contribution level. That is the major issue because it is the same as how you actually collect your taxation from somebody who puts in an annual tax return and those sorts of things. I would anticipate that we would apply it in exactly the same way as we apply the current taxation system, with quarterly returns and self-assessment—the Medicare collection is done in exactly the same way.<sup>11</sup>

6.19 A number of submissions called for the alignment of self-employed and employee arrangements. For example, the Institute of Chartered Accountants in Australia (ICAA) submitted that:

...the self-employed are at a disadvantage to other employed persons, as employers are able to claim a deduction for 100% of contributions up to the age-based limit. Employed persons are able to salary sacrifice up to the age-based limit and take full advantage of the 15–30% tax rate applied to contributions, while the self-employed are unable to do so due to the discounted deduction rules.

We recommend the removal of the limitation on contribution deductibility for self-employed persons to provide equity to those in employment relationships.<sup>12</sup>

6.20 The issue of self-employed workers was also raised by Cbus in its submission. Cbus noted:

Many employees in the building and construction industry move between periods of self-employment and paid employment and may not necessarily make sufficient superannuation contributions while self-employed.<sup>13</sup>

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9 *Committee Hansard*, 10 July 2002, p. 267.

10 *Committee Hansard*, 9 July 2002, p. 185.

11 *Committee Hansard*, 9 July 2002, p. 189.

12 *Submission 31*, ICAA, p. 3.

6.21 Remedies which were recommended by Cbus to assist the self-employed included:

That low income earners be able to claim a tax deduction for employee contributions.

That low income earners with limited superannuation assets (small accounts) be able to claim a rebate of the superannuation contributions tax which would be paid into their nominated superannuation fund.<sup>14</sup>

6.22 AMP Financial Services (AMP) recommended that in order to increase savings by the self-employed:

... the tax free threshold on superannuation contributions (set to rise to from \$3,000 to \$5,000) should be indexed to average earnings. This allows the threshold to move automatically year to year, rather than on an ad hoc basis.<sup>15</sup>

6.23 The AMP also made the following comments on the ability of small business owners to support their retirement from the proceeds of a business sale:

Encouraging this group to save more is important. Relying on the sale of a business for retirement income has a high level of risk associated with it, as it relies on the business being successful, and the expected value of the business being realised on sale.<sup>16</sup> As a result, self-employed people are more exposed than employees to the risk of retiring with less funds than anticipated.<sup>17</sup>

6.24 On the issue of the ability of small business owners to support their retirement from the proceeds of a business sale, Treasury explained in a supplementary submission that:

... the law encourages small business owners to use the proceeds of the sale of their business for retirement purposes by disregarding a capital gain where the proceeds of the sale of an asset are rolled-over into a

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13 *Submission 42*, Cbus, p. 8.

14 *Submission 42*, Cbus, p. 13.

15 *Submission 64*, AMP, p. 15.

16 See footnote in AMP submission: 'Many self-employed persons rely on their business to provide for their retirement rather than contributing to a superannuation fund, and usually reject the notion of compulsory superannuation on this basis. This position has been entrenched with the policy changes allowing the use of a business as the source of retirement income, with the capital gains on the sale of a business being tax free (up to certain limits) if the funds are used for retirement purposes. See *Submission 64*, AMP, p. 15.

17 *Submission 64*, AMP, p. 15.

superannuation fund and used for retirement (up to a lifetime limit of \$500,000).<sup>18</sup>

6.25 Whilst Treasury made no comments in relation to changing the current arrangements for the self-employed as part of this inquiry, Treasury did address this issue as part of their submission to a previous inquiry conducted in June 2002. At that time Treasury indicated that bringing the self-employed into line with the employee limits would have budgetary implications.<sup>19</sup>

## **Member protection**

6.26 Although not a major issue in evidence to the inquiry, the issue of protecting small account balances from erosion due to the effect of fund fees and charges, did arise.

6.27 The development of member protection strategies became necessary as a result of transitional issues associated with the introduction of compulsory superannuation through the SG. One of these transitional issues was the erosion of small account balances through the impact of fees and charges. This was in the nature of a transitional issue where many people were new to superannuation and contribution levels were low. Accordingly, from 1 July 1995, funds that wanted to accept new members were required to protect account balances of less than \$1,000 from the impact of fund fees and charges where they exceeded fund interest. For these purposes 'fees and charges' comprise entry and exit fees, periodic administration charges, and asset fees. Charges for tax, insurance, and for investment losses are not protected.

6.28 While it is up to the individual fund how they do this, in general these small account protection costs are subsidised by members with larger account balances. These cross subsidies can be quite large, especially when fund earnings rates are low or even negative. For example, Mr Luke from Sunsuper submitted during the Canberra roundtable discussion on 8 October 2002:

One of the major problems with member benefit protection is that people can have 50 different accounts and they get member benefit protection on each account. Somehow, there needs to be some roll-up, because we are all bearing an enormous cost in providing member benefit protection for people under that \$1,000. Lots of different providers can have it. The cost to us as an organisation was about \$8 million in the last year in forgone fees. That is out of a total fee income for us of around \$26 million to \$27 million, so it is an enormous amount of money and, in a bad year, it can affect you.<sup>20</sup>

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18 *Submission 142*, Treasury, p. 8.

19 Senate Select Committee on Superannuation *Report on Taxation Laws Amendment (Superannuation) Bill (No.2) 2002 and Superannuation Guarantee Charge Amendment Bill 2002*, June 2002, p. 9.

20 *Committee Hansard*, 8 October 2002, p. 705.

6.29 In response to Committee questioning about people's desire to consolidate their superannuation into fewer accounts, Mr Luke said that 'people do not care. They have superannuation all over the place and they do not put it together.'<sup>21</sup>

6.30 Similarly, Ms Doyle from the AMP also advised the Committee that people with small account balances could consolidate their accounts, but that they don't care enough to do so:

I suggest that at the moment it is quite easy for members to accumulate their balances if they want to. Given that there is a lot of money in RSAs, ERFs and those sorts of things, it really comes down to people not caring enough about wanting to get their balances together, because most of the public offer funds allow members to accumulate their balances. I would be surprised if there was a corporate fund that would not allow rollovers as well.

As for people being able to say, 'I had employment money here, here and here over my lifetime,' and being able to touch on those funds and then say, 'I want to roll up my balances and put them into my current fund,' there is not really a problem in trustees enabling people to do that. It comes down to issues such as people not caring enough to accumulate those balances, rather than there being restrictive trustee rules or anything like that which prevent people from accumulating those balances.'<sup>22</sup>

### **\$450 earnings threshold**

6.31 Another transitional arrangement that has remained in place since the introduction of the compulsory SG is the contributions earnings threshold of \$450 per month. Employers are not required to pay contributions in respect of any employee who does not earn \$450 in any month. However, many awards and other workplace arrangements require the employer to make payments irrespective of the earnings of the employee.

6.32 The earnings threshold was introduced to minimise the employer administration effort in highly casual areas of employment, such as in seasonal agriculture. This was considered necessary when the compulsory superannuation arrangements were new, administration and payroll systems were somewhat embryonic by contemporary standards, and the contribution levels were relatively low.

6.33 In commenting on the level of the earnings threshold in the relation to the growth in the level of the SG, Dr Anderson from ASFA advised the Committee in the hearing on 8 August 2002 that it was currently consulting with its members to determine their views on the potential to lower the threshold in order to reflect the increased level of employer contribution:

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21 *Committee Hansard*, 8 October 2002, p. 705.

22 *Committee Hansard*, 8 October 2002, p. 705.

The reason we said that we may be able to lower it was that, if you did your sums, you could say: 'We started at three per cent, and put it at \$450. Can we use the same assumptions now we are at nine per cent?'<sup>23</sup>

6.34 Ms Smith from ASFA also pointed out changing employment patterns are also relevant, because people can have income from a variety of employers, and the threshold applies in respect of each employer, where there is more than one, rather than an individual's total income:

... with changing work patterns, what was reported to us ... was the increased frequency for people in casual work to have multiple employers. What they are doing is patching together an income from a variety of employers.<sup>24</sup>

6.35 COTA expressed the view that the current \$450 minimum threshold for contributions should be abolished. COTA indicated that:

Employees with a portfolio of part-time and casual jobs may not make any Superannuation Guarantee contributions at all as their employment with each employer does not put them over the monthly threshold of \$450 at which contributions are required. As the Superannuation Guarantee is an employer cost, extension of the 9% contribution to these workers would not reduce the individual incomes of these, often low income workers. There is little justification for not extending the Superannuation guarantee to all workers, irrespective of income.<sup>25</sup>

6.36 The National Seniors' Association (NSA) was also critical of the impact of the current \$450 threshold on those with broken working patterns, in particular women, and suggested a remedy to address the concerns for employees aged 50 years or more:

Superannuation regulations work against people engaged in part-time work. Employers are not required to contribute superannuation towards employees earning less than \$450 a month. This is a problem for older workers who are either unable to find full-time work after being made redundant or choose to make a gradual transition into retirement. It also makes it near impossible for people taking up 'portfolio employment' or several part-time jobs with different employers to accumulate superannuation.

To address this, NSA recommends allowing maximum entitlement to superannuation for casual employees over 50 who may be earning less than \$450 per month taxable income from any single employer but more than \$450 per month in total from several employers.<sup>26</sup>

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23 *Committee Hansard*, 8 August 2002, p. 601.

24 *Committee Hansard*, 8 August 2002, p. 602.

25 *Submission 63*, COTA, pp. 17-18.

26 *Submission 60*, National Seniors Association, pp. 4-5.



6.37 The Women's Economic Policy Analysis Unit, of Curtin University of Technology provided an example of how the current \$450 earnings threshold impacted in circumstances where women work in more than one part-time job. The Unit explained in its submission that a woman could receive the same lifetime earnings by working in two part-time jobs, one of which has earning of less than \$450 per month, or in one full time job. The difference in lifetime superannuation, however, is that the two part-time jobs attract 20 per cent less superannuation than the one full-time job.<sup>27</sup>

### ***Committee view – other adequacy issues***

#### *Self-employed*

6.38 The Committee notes that the weight of evidence supports the extension of the arrangements available to employees to the self-employed. The Committee notes that, although there might be budget implications, no policy objections were raised to the alignment of the taxation treatment for superannuation contributions of employees and the self-employed.

6.39 The Committee considers that the nature of work should not affect the tax treatment of contributions to superannuation. Indeed the Committee is aware that the different tax treatment of employer, employee pre and post tax, and self-employed contributions adds significantly to the complexity of the superannuation system.

6.40 The Committee has considered the extension of the compulsory SG system to the self-employed as advanced in some of the evidence. On balance the Committee does not support this extension at this time. This is because of the uncertain and volatile nature of the income of the self-employed. The Committee considers that the question of adequacy of retirement incomes for the self-employed is best addressed through appropriate tax arrangements for voluntary contributions and sale of business assets.

#### *Member protection*

6.41 The Committee notes that the effect of cross subsidies of the cost of fees and charges between members of superannuation funds in order to maintain the member protection rules can be quite high. In addition the Committee notes that, while there is a great deal of cross subsidisation, the genuine low account holder feels aggrieved that he or she is meeting a tax commitment while there is no addition to his or her balance.

6.42 The Committee is aware that the member protection rules add considerably to the complexity of fund administration including the effect they have on determining the annual crediting rate. The Committee also notes that superannuation funds are able to transfer inactive small accounts to an Eligible Rollover Fund that are

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27 *Submission 75, WEPAU, p. 28.*

established for the primary purpose of ensuring that administration fees do not erode small account balances.

6.43 The Committee is aware that the average superannuation fund member currently has about three accounts and that there are barriers that prevent many people from merging those accounts. The Government is currently examining proposals to facilitate account consolidation and associated portability. The Committee considers that those arrangements will provide some opportunity for minimising the effect that administration fees have on multiple small accounts, however their effectiveness is likely to be hampered where substantial entry and exit fees apply. The Committee believes that effective arrangements for account consolidation will substantially reduce the cost of member benefit protection, which should be retained to protect the small accounts that remain.

#### *Earnings threshold*

6.44 The Committee considers that the existence of the \$450 contribution threshold was necessary as a transitional arrangement in 1992 while the level of compulsory employer contributions was quite low. However, the Committee notes that there is now more casual and part-time employment than when the SG was introduced. This means that those employees who have ‘portfolio’ employment may not be getting employer supported superannuation as the level of earnings with any one employer may not exceed the threshold.

6.45 The Committee is also aware that the shortfall in the adequacy targets identified in this report is higher for those on low incomes. It follows that any initiatives that assist low income earners to boost superannuation savings would be a welcome development.

#### **Recommendation**

6.46 **The Committee recommends:**

- **examining the option of extending to the self-employed a framework for making superannuation contributions, with tax treatment similar to that which applies to employees making contributions; and**
- **examining the removal of the \$450 earnings threshold for SG contributions.**

#### **People with broken work patterns**

6.47 The Committee was also concerned that people with broken work patterns, often women, might also find themselves with an inadequate income in retirement. This is because, in order to meet family and other responsibilities, they will not necessarily have the benefit of a full working life under the compulsory superannuation system. Their contributions levels are also likely to be smaller because many women’s careers are not usually as long as their male counterparts and their incomes tend to be lower.

6.48 The ICAA advised the Committee that the age-based deductible limits discriminate against two groups:

- occupations where income is weighted toward early years in the work force, such as sports people and entertainers; and
- women planning a broken work pattern to have a family.

6.49 The ICAA elaborated that:

In both these cases the individual has a higher disposable income early in their working life and may not have an opportunity to contribute to superannuation later in life.<sup>28</sup>

### ***Committee view – people with broken work patterns***

6.50 The former Select Committee on Superannuation reported on this issue in 1995.<sup>29</sup> In that report, among other matters, the recommendations aimed at addressing shortfalls in superannuation for those with broken work patterns, included permitting contributions for people over age 65, the adoption of appropriate fund transfer protocols, and the development of awareness and educational material for women.

6.51 The Committee considers that a number of the measures it has recommended in this report may assist women, and others with broken work patterns, to achieve an adequate income in retirement. These measures include:

- examining the removal of the \$450 earnings threshold;
- removing the work test for making voluntary contributions; and
- extending the government co-contribution concept.

6.52 In addition, as considered in other parts of this report, measures relating to the phased removal of front-end taxes in the long term, including the contributions tax and the surcharge, and incentives to extend working lives may also assist women and others with broken work patterns.

## **Overall conclusions – adequacy**

### *Identifying and quantifying adequacy*

6.53 The Committee found that there is a need to define the meaning of the term ‘adequacy’ of superannuation. In particular, there is a need to establish clearly articulated objectives for Australia’s retirement incomes system, which include targets for representative groups of Australians.

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28 *Submission 31, ICAA, p. 3.*

29 Senate Select Committee on Superannuation, Seventeenth Report, *Super and Broken Work Patterns*, November 1995.

6.54 In order to provide an adequate standard of living in retirement, the Committee notes the high degree of consensus expressed by witnesses at the roundtable that the desirable target for a person on average earnings is a replacement rate of 70-80 per cent of pre-retirement expenditure (which equates to approximately 60-65 per cent of gross pre-retirement income), a target which would need to be higher for those on less than average weekly earnings, and lower for those on high incomes.

6.55 The Committee found that, should this replacement rate be accepted, the available modelling shows that the current arrangements are unlikely to deliver these outcomes, and that other strategies are required to address the anticipated shortfall.

#### *Closing the adequacy gap*

6.56 The Committee considers that strategies to close the adequacy gap include more incentives for voluntary contributions, including expanding the government co-contribution concept by raising the threshold and improving coverage to lower to middle income earners, and widening access to superannuation as a savings vehicle by removing the work test for making voluntary contributions, lowering front-end taxes in the long term, providing a cost-effective savings vehicle, and permitting contribution of non superannuation assets to superannuation.

6.57 The Committee considered the evidence in favour of additional compulsory contributions by either employers or employees, but concluded that these could not be supported in the current economic climate.

#### *Factors inhibiting adequacy*

6.58 The Committee noted that a number of factors inhibit the effectiveness of the current contributions in delivering adequate retirement incomes, including the impact of front-end taxes, the impact of fees and charges and the impact of rising household debt.

6.59 Although the Committee received no compelling suggestions on how the revenue shortfall could be addressed if front-end taxes were removed or reduced, the Committee favours a gradual move away from front-end taxes. The Committee also re-emphasises the importance of transparent disclosure up front of fees and charges, and notes that there is a need to monitor the relationship between the effect of household debt and the ability of people to save for retirement.

#### *Baby boomers*

6.60 Given that the compulsory superannuation scheme has only been in operation since 1992, the Committee notes that most baby boomers will not have the benefit of a full working life under the compulsory superannuation system and, other savings aside, that their incomes in retirement are likely to fall well short of the consensus target level of 70-80 per cent of pre-retirement expenditure (approximately 60-65 per cent of gross pre-retirement income). The Committee considers that a number of its recommendations for change which apply to the wider community will also assist baby boomers to achieve an adequate income in retirement.

*Other adequacy issues*

6.61 The Committee notes that there are a number of arrangements which could impact on the adequacy of individuals' or groups' retirement incomes. These include:

- arrangements for the self-employed;
- member protection arrangements; and
- the \$450 SG earnings threshold.

6.62 The Committee has identified in this report a number of strategies to assist people affected by these measures to improve the adequacy of their income in retirement, including examining the extension to the self-employed of the same contribution arrangements that apply to employees, and examining the removal of the \$450 earnings threshold.

6.63 The Committee has also identified strategies to assist women and others with broken work patterns, to achieve an adequate income in retirement.

