FURTHER SUBMISSION TO THE SENATE SELECT COMMITTEE
ON
SUPERANNUATION AND
STANDARDS OF LIVING IN RETIREMENT

INTRODUCTION

This further submission in relation to the Superannuation Surcharge has been prepared for the Society of Superannuants by Donald Steel, Actuary and Adviser to the Society and follows on evidence given to the Committee on Monday, 1 July 2002 at hearings in Canberra.

RECAPITULATION OF POINTS MADE ON 1 JULY 2002

Some explication of the points made is included here.

Accumulation funds which are not fully vested

Surcharges result in the taxation of some contributions, the benefits from which will be forfeited. Plainly this is unjust and indefensible.

Defined benefits funds

Cap of 15% on the post 20 August 1996 employer financed component of benefits

Evidence was tendered by the Society that high earnings rates employed for the accumulation of surcharge debts can be expected to give rise to surcharge debts in excess of 15% of the post 20 August 1996 employer financed component of lump sum benefits.

A cap on the debt was suggested as a means of reducing the inequity arising from the growth of surcharge debts at fund earning rates higher than the rate of growth of the salary of a member.

It needs to be remembered that the surcharge is a graduated tax. Some members are surcharged at rates well below the 15% ceiling. A 15% cap is too high in these cases.

The application of a cap would add to the complexity of an already incomprehensible tax.

It is also relevant that the employer-financed component of a contributory defined benefits fund is not readily identified. It needs to be estimated by actuarial methods that involve assumptions about future experience in respect of the many factors that influence the outworking of a defined benefits fund. Different assumptions give rise to different employer financed proportions of benefits.

I am of the opinion that a cap is not a satisfactory solution to the inequities of the surcharge in relation to defined benefits funds.

The use of sticking plaster to support an unsupportable structure must be avoided.

Averaging across benefits

Defined benefits funds provide a range of benefits all of which are of significantly different worth.

No one knows for which benefit any particular member will qualify.

Surcharges are therefore calculated on the basis of the probabilities of each member qualifying for each of the benefits, that is, by assuming that each member will receive a statistically assessed proportion of each benefit. It is trite (but true) to say that any particular member can receive only one benefit. Averaging means that taxes will be overstated for those who receive benefits of low value and understated for those who receive benefits of high value.

It is respectfully submitted that averaging has no place in the assessment of taxes levied on individual citizens.

The Government has recognized that Surcharge debts are wrong. The Explanatory Memorandum to the Superannuation Legislation Amendment (Superannuation Contributions Tax) Bill 1997 has this to say about surcharge debts in unfunded Commonwealth public sector schemes.

> **It is proposed that benefits should not be reduced by more than 15% of the employer-financed component of a benefit accrued after 20 August 1996. In general, trustees will have discretion to allow reductions to be applied in a fair and equitable manner taking various matters into account. This discretion is necessary in cases where actual benefits are considerably more, or less, than the projected benefit on which the surchargeable contributions (and therefore the surcharge tax) has been based.**

This statement is a straight-out admission that surcharge debts are wrong. The Government's own words damn the Superannuation Surcharge.

The words may have misled the Parliaments. They refer to "discretions to allow reductions". No mention is made of applying increases where the actual benefit is more than the projected (averages!) on which the surcharge taxes were based.

The revision of surcharge debts at benefit emergence in private sector defined benefits funds along the lines that apply in Commonwealth public sector unfunded schemes would be extremely complex and would add considerably to the costs of an already frightfully complex tax.

The Committee is asked to note the remarks made earlier that the 15% cap referred to in the above extract, is too high in those cases, probably the majority, where Adjusted Taxable Incomes during the post August 1996 period of service attracted rates of surcharge below 15%.

Averaging across members

The basis of calculation of surcharges includes an assumption that the salaries of all embers will increase at 4.5% per annum. It is well known that final salary type defined benefits funds are most favourable to members whose salaries progress most rapidly and particularly to those who are promoted late in their working life and least favourable to those whose salaries are flat.

The imputing of a common rate of salary increase to all members is a particularly repugnant form of averaging.

A person who asserted that the income tax of Canberrans should be based on an average income calculated by adding up the salaries of all Canberrans and dividing by the number of them, would be ridiculed. Such averaging is precisely the principle that applies to calculation of superannuation surcharges in defined benefits funds (other than those public sector funds for which an attempt at equity is made at benefit emergence).

Consider the case of John Smith who has completed thirty years of recognized service under the rules of the defined benefits fund to which he belongs, when he is promoted to the position of Chief Executive. His salary is quadrupled. His accrued retirement benefit for the 30 years of completed service is quadrupled. The enormous increment in those benefits for completed service escapes the surcharge.

Sometimes a benevolent employer retains a senior employee who suffers ill health, on a constant or reduced salary. Surcharge debts are incorrect in such cases and in at least some of them, can only be described as disgraceful.

I respectfully submit that the surcharge is seriously flawed and deserves to be repealed as a matter of extreme urgency to prevent continuation of gross inequities. Its application to defined benefits funds and to accumulation funds that are not fully vested is totally inappropriate for personal taxation.

POINTS ADDITIONAL TO THOSE MADE ON 1 JULY 2002

Revision of surcharge debts at benefit emergence

I would like to throw another bucket of cold water on any suggestion that revision of surcharge debts at benefit emergence, in defined benefits funds and accumulation funds that are not fully vested) would be a solution. Proper assessment of the worth of employer-financed benefits actually received cannot be made until payment of benefits has finished. A pension may cease very soon after its commencement resulting in a benefit of minimal worth. In other circumstances, a spouse's survivorship pension may continue for half a century after the retirement of a fund member resulting in employer-financed benefits of great worth. It would be impractical to levy a tax at that time, the earliest time that the worth of the benefit could be estimated.

Revision of surcharge debts, including nil debts, at benefit emergence or when payment has been completed would give rise to some increases and in some reductions in debts estimated during service and the imposition of some debts where none had been foreshadowed during service. In my opinion, additional imposts would be unacceptable and quite inappropriate as parts of a rational taxation system.

It would be a fluke if any surcharge debt estimated during service proved to be correct.

The future is an expanding funnel of doubt

The basis on which surcharges for members of defined benefits funds are estimated involves assumptions about the future.

Notional employer contributions to defined benefits funds are estimated on the basis of assumptions about the future experience of the fund with respect to the numerous factors that influence the financial outworking of the fund.

The regulations specify that investment earnings (net of the tax on investment income and investment-related expenses) are to be assumed at 8% per annum, salary growth is to be assumed at 4.5% per annum and inflation at 2.5% per annum.

These assumptions will not accurately portray the future financial experience of any fund. The difference between the investment return assumption and the salary growth assumption, 3.5% per annum, is generally more significant than the absolute levels of these factors. Reference has been made earlier to the markedly different salary growth patterns of members of any one fund. No set of assumptions can reasonably portray the financial future of any fund for any or all of its members.

Assumptions are also made in respect of other factors that are relevant according to the rules of the particular fund. These other factors will usually include resignation, death and disablement, and may include sex, proportions married and age differences between members and their spouses. The assumptions may be different for active members and pensioners. Some funds provide choices of benefit form. The model of a fund's outworking will allow for the structure of benefits of that fund.

For some very large funds, the statistical basis may be drawn from analysis of its own past experience. For other funds, the statistical basis will be drawn from sources that the actuary considers to be reasonable for the membership of the particular fund.

It has been said that nothing is permanent but change. No matter how the statistical basis has been formulated, it is, at best, an estimate of future experience that will not accurately portray the future.

Members of the NSW Police Superannuation Scheme are up in arms at this very time because of enormous hikes in the amounts of their surchargeable contributions. In some cases the surchargeable contributions are as high as

50% of salary. 40% is commonplace. The NSW SAS Trustee Corporation has stated that the principal reason for the hikes in surchargeable contributions is an increased incidence of hurt on duty disability claims. This is cited as an example that the statistical bases, no matter how carefully they are constructed or drawn cannot portray the future. Experience changed and it will change again and again. The future cannot be predicted. The future is an expanding funnel of doubt.

The distillation of all this analysis is used for the calculation of Notional Superannuation Contribution Factors (NSCF's).

NSCF's involve

averages across benefits
averages across members and
predictions of the future.

No wonder they are called **<u>Notional</u>** Superannuation Contribution Factors.

Notional employer contributions do not equate to actual employer contributions for any defined benefits for any period of operation of a defined benefits fund

It is respectfully submitted that notional employer contributions have no proper part in the assessment of personal taxes.

I repeat, the basis of assessment of superannuation surcharges is seriously flawed in relation to defined benefits funds .

I submit that it is impossible to know what the future holds for the experience of any defined benefits fund or what the eventual benefit of any member of any defined benefits fund will be and that it is therefore impossible to calculate the employer contribution in respect of that member for any year or other period during the service of that member

Defined benefits funds are inherently inequitable

Defined benefits funds are inherently inequitable. The levels of employer subsidy, elusive as they are, are very different for different members and indeed for members with similar characteristics whose membership spans different periods.

Investment conditions at the point of emergence of lump sum benefits are a particular source of inequity that is external to the direct operation of the funds. Members who draw lump sum benefits when asset values are depressed receive sufficient cash to purchase larger parcels of assets than members with similar characteristics who draw their lump sum benefits when the market is near a zenith.

Their inequity does not mean that defined benefits funds should be condemned. They fulfill a variety of needs. No one can be sure what his or her eventual need will be

A pension related to salary at or near retirement, payable for life with a reasonable reversionary pension for a surviving spouse and indexed in line with changes in the cost of living is the ideal form of retirement benefit. Funds that provide such benefits certainly do not deserve condemnation. These funds answer needs – they do not attempt the equity of fully vested accumulation funds.

The inequity of benefits of defined benefits funds must not be carried through into personal taxes. The surcharge adds injury to the inequity of these funds. Surcharges are overstated for members who receive the poorest benefits and understated for those who receive the most valuable benefits

About periodic actuarial investigations of the financial condition of defined benefits funds

It is not possible to be precise about the accrued liabilities of a defined benefits fund at any point in time. Periodic actuarial investigations into the financial condition of defined benefits funds are made on a collective basis (even though the arithmetic may be done on an individual member basis because of the power of modern computers to process individual member files) with the objective of forming an opinion about financial condition. These investigations do not measure the amount of the fund against a particular sum that the fund ought to hold because there is no such particular sum. The actuarial process may be likened to aiming for a target which is known to exist somewhere in quite a large area. Periodic investigations are essential to continue re-aiming for the target that continues to move, as does that area within which it is known to exist. It is probable that most citizens ascribe precision to actuarial valuations of defined benefits funds that is not intended by the actuaries who made them.

The imprecise nature of actuarial assessments where the future is involved needs to be recognized.

Comprehension

Any system of personal taxation should be capable of being understood by the general community. Taxpayers ought to be able to check their tax assessments or, at the very least, be able to establish that their taxes are of the correct order. Superannuation surcharges are not understandable except by a small, select group of citizens.

It has been said that wherever work is done mistakes will be made. It is unlikely that mistakes in surcharge assessment will uncovered because the tax is incomprehensible.

An incomprehensible tax is a bad tax.

The Superannuation Contributions Tax (Assessment and Collection) Regulations 1997 are a veritable nightmare.

Administration

The administration of the surcharge is expensive and difficult for the funds and for the Australian Taxation Office. In many cases, the expense of reporting to the ATO, of maintaining records of accumulated surcharge debts and informing members exceeds the amounts of surcharge collected.

In my opinion the administration costs of the surcharge are disproportionate to the revenue raised.

If the net loss to revenue by repealing the surcharge legislation needs to be replaced a small increment in the top marginal rate of tax would be simple.

The Government has contended that the surcharge is an equity measure. The truth is that it is seriously inequitable in the case of defined benefits funds and accumulation funds that are not fully vested.

The so-called Reasonable Benefits Limits and deductible contribution limits restrict the opportunity for high income earners to exploit the superannuation system. (The deductible contribution limits are largely ineffective for defined benefits funds.)

I commend the repeal of the surcharge to the Parliaments.