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Human Resource Consulting

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13 July 2006

General Manager
Superannuation, Retirement and Savings Division
The Treasury
Langton Crescent
PARKES ACT 2600

Subject:

Mercer Submission No. 2 – Deductible Contributions

Dear Sir

This is the second submission made by Mercer Human Resource Consulting in response to the Government's Plan to Simplify and Streamline Superannuation.

Key Government proposals covered in this submission

- Imposition of an annual limit on deductible contributions that are concessionally taxed
- Flow on effects from such a limit including the effective commencement date, transitional arrangements, exemptions from the limit and the impact where a member has not supplied a TFN.

Executive Summary

The introduction of a limit on deductible contributions will mean that rules and procedures will need to be put in place to monitor and control the limit. As with the limit on undeducted contributions, we note that the proposed limit is only likely to impact on a very small proportion of superannuation fund members. It is therefore critical that the rules and procedures are easy to understand and simple and cost effective to operate.

Whilst we would prefer, on simplification grounds, that no limit apply, we can understand the Government's concerns that a limit should be applied. However, we believe that **the proposed limit is too low and should be increased to \$100,000**. It is likely that few people will be able to contribute significant amounts before about age 50 due to family and mortgage commitments etc. The removal of the age based limits is therefore unlikely to have a significant impact at these younger ages. The introduction of a \$50,000 concessionally taxed limit (about half of the current age

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based deductible limit) may however considerably reduce the ability of these people to effectively fund their retirement in the later years when they may have a higher ability to save. The proposed limit should also be **indexed** in line with movements in AWOTE.

The balance of our submission concentrates on the reporting mechanism and the rules and procedures surrounding the limit.

In our view, the proposed system retains many of the problems associated with the superannuation surcharge and modifications need to be made to enable the system to operate smoothly and without a significant cost impact on superannuation funds and their members.

There are several major aspects which need to be modified (or clarified) in order to make the limit more workable.

In addition, the Government's proposals enable high income earners to make excessive deductible contributions on a tax effective basis and allow these contributions to remain in the fund. This approach contrasts the proposals for excessive undeducted contributions which require refunding.

We consider it important that this anomaly be removed. In our view this can be achieved simply and equitably. As indicated in our attached submission, we would replace the proposed undeducted contribution limit with a combined limit (equal to the sum of the deductible and undeducted limits). Clearly it would be easier if the proposed complex averaging system was replaced by a simpler transitional limit as recommended in Submission No.1.

A penalty tax of 20% of the excess of the total contributions over the combined limit would then be applied. Such a penalty would strongly discourage excessive contributions irrespective of whether they are undeducted or deductible contributions. This penalty tax would be in addition to the Government's proposed additional tax on excessive deductible contributions. By combining the limits and applying a significant penalty, there would be no need to require excessive contributions to be refunded and a more equitable treatment of undeducted and deductible contributions will result.

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Our proposals are best summarised by the following process.

The method we propose for operating the limit on concessional tax contributions can be summarised as follows:

- The proposed limit on undeducted contributions would be replaced by a combined limit equal to the sum of the undeducted and deductible contribution limits;
- A limit on concessional tax deductible contributions would continue to apply as proposed;
- Funds will only deduct 15% contribution tax from deductible contributions (irrespective of whether a TFN has been supplied) and will not be required to check whether the maximum limit has been exceeded;
- Funds will report the contributions to the ATO using mechanisms similar to those previously required for surcharge;
- The calculation of notional contributions for defined benefit funds and allocated surplus amounts for accumulation arrangements will be considerably simplified (we will cover this aspect in more detail in a later submission);
- The ATO will determine whether either or both of the deductible contribution limit or the combined limit have been exceeded and determine whether any additional tax (including any additional tax due because the member has not supplied a TFN) might be payable;
- The ATO will liaise directly with the member (or the member's tax agent) to:
 - obtain a TFN, if needed;
 - confirm that the contributions reported are correct;
 - confirm that the member, if self-employed, has not subsequently advised the fund to treat some undeducted contributions as deductible;
- The ATO will then, if necessary, issue an assessment to the member (not the fund) reflecting:
 - the additional tax (30% of any deductible contributions in excess of the deductible contribution limit); and
 - the additional penalty tax of 20% on any contributions in excess of the combined limit;
- The member can either pay the tax or request a superannuation fund to pay it on his/her behalf.

This approach will enable early application of the new rules whilst effectively minimising additional costs to funds. Whilst it may appear that additional work would be placed on the ATO, we consider that our proposals will discourage excess contributions and, as a result, there will be very few cases of excess contributions. It is also likely that, if excess contributions have been made, the member is likely to be using a tax agent, so most liaison could be through the agent rather than the member.

The liaison between the ATO and the member (or agent) will enable errors to be rectified and TFNs to be obtained where necessary. The member will also be made acutely aware of the tax consequences so that future excessive contributions are unlikely. This will provide greater discouragement of future excesses than if assessments are issued to the fund. It would also remove

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the problem applicable under surcharge where funds were assessed for tax when they no longer held the contributions.

In addition, modifications to legislation in relation to TFNs would be made to make it mandatory for employers to provide its employees' TFNs to the fund (unless the employee had provided an instruction not to do so). These provisions would increase the workability and hence the desired outcome of the new arrangements. Unless such modifications to enable more effective provision of TFNs are put in place, we expect that the administration costs for both funds and the ATO will be extreme.

The attached report sets out more background and reasoning behind the process recommended above.

These recommendations, together with a series of other important but less crucial recommendations are set out in Appendix 1 to this letter.

In Appendix 2, we have listed the previous submissions made by Mercer on the discussion paper. We intend making several more submissions over the next few weeks.

Please contact either John Ward (03 9623 5552) or David Knox (03 9623 5464) if you wish to discuss any of these issues.

Yours Sincerely



Peter Promnitz
Chief Executive

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APPENDIX 1: Mercer Recommendations In Relation To Deductible Contributions

Recommendations	Discussion Paper Reference	
General Policy – Refer to Section 1 of attached report		
1.1	If the Government proceeds with its proposed model, further consideration is necessary to minimise the problems (previously seen in relation to surcharge) – refer to recommendations in Section 2.	4
Ways of Streamlining the Proposed System – Refer to Section 2 of attached report		
2.1	In order to meet the Government’s aim of simplification, the legislative requirements must be enacted using plain English and using words which are clearly understood.	
2.2	The method for determining notional contributions for defined benefit funds must be considerably simpler than the methodology required for surcharge purposes.	4.2
2.3	Any requirement to treat allocated surplus amounts as deductible contributions must be much simpler than the methodology required for surcharge purposes.	
2.4	All monitoring of the limits should be conducted by the ATO. Funds would not be required to determine whether the deductible contribution limit of \$50,000 pa (or \$1,000 for members who have not supplied a TFN) has been exceeded and would only deduct 15% contribution tax.	4.4.2 and 7.2.1
2.5	The ATO should liaise directly with the member to ensure that any assessment is correct and then issue the assessment for any additional tax to the member.	
2.6	The member would be able to request any relevant superannuation fund to pay the tax on his/her behalf.	

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2.7	A fall-back position may be required where the ATO can actually issue an assessment on a relevant superannuation fund if the ATO has been unable to obtain a response from the member.	
2.8	TFN legislation should be amended to make it mandatory for employers to pass on employees' TFNs (where known) to their relevant superannuation fund (unless there is a positive direction by the employee to the contrary.)	7.2
2.9	The ATO should consider writing to all members who have not supplied a TFN to their fund to encourage them to do so. (The ATO mail-out could be based on the latest surcharge reporting).	7.2
2.10	As full details of reporting requirements and the calculation process for notional contributions are unlikely to be available until shortly before 1 July 2007, it is unlikely that funds will be able to modify systems in time to report these details to rollover funds in respect of rollovers occurring shortly after 1 July 2007. It may therefore be necessary to ignore notional contributions in respect of rollovers for a short period after that date.	

Is the Proposed Limit Appropriate? – Refer to Section 3 of attached report

3.1	A higher limit than \$50,000 pa should apply. To be more consistent with current age based deductible limits and to allow couples more ability to increase their retirement benefits, a limit of \$100,000 pa should apply.	4.2
3.2	The concessionally taxed limit (and any transitional limits) should be indexed in line with movements in AWOTE.	
3.3	Any indexed values should be rounded to the nearer \$1,000. It would also be preferable for a fixed relationship to be established with the limit for undeducted contributions (or a combined limit as per Recommendation 8.2). For example the undeducted contribution limit, except during any transitional period, could be set at 1.5 times the concessionally taxed limit for deductible contributions – assuming this limit is increased to \$100,000.	

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Transitional Arrangements for Individuals Aged 50 and Over – Refer to Section 4 of attached report

4.1	The \$100,000 transitional limit applicable for any year (up to 30 June 2012) should not only apply to all individuals who have either reached age 50 in that year or an earlier year (as clarified in the Government's Fact Sheet) but also to individuals who would have reached age 50 in that year (eg those who die before reaching age 50).	4.4.2
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Non 30 June Company Tax Years – Refer to Section 5 of attached report

5.1	For employers with a tax year that ends on a date earlier than 30 June 2007, all employer contributions made during the employer's 2007/2008 year should be tax deductible.	4.4.2
5.2	For employers with a tax year that ends on a date after 30 June 2007, all employer contributions made after 30 June 2007 should be tax deductible with only contributions made before 1 July 2007 being subject to the age based limit.	4.4.2

Deductibility of Employer Contributions - Refer to Section 6 of attached report

6.1	As indicated in the Government's proposals, employers should be able to claim a tax deduction in respect of all eligible employees up to age 75; although we consider that the age limit should be removed entirely.	4.4.2
6.2	All employer contributions to a defined benefit fund (including for pensioners) should be tax deductible so that employers can continue to ensure the security of pension benefits.	4.4.2

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What Should Not Be Included in Any Limit? – Refer to Section 7 of attached report		
7.1	Amounts transferred from overseas retirement plans should not be included with deductible contributions for the purposes of the proposed test.	4.6.1

Excess Contributions – Refer to Section 8 of attached report		
8.1	The Government's proposals involve different mechanisms for restricting deductible and undeducted contributions. The different mechanisms restrict individuals from making excess undeducted contributions however high income earners can make unlimited excessive deductible contributions on a tax effective basis. This anomaly needs to be removed.	4.4.2 and 4.5.1
8.2	To remove the anomaly, the limit on undeducted contributions should be replaced with a combined limit equal to the sum of the deductible contribution limit and the undeducted limit. A 20% penalty tax, assessed by the ATO, should be applied in respect of all contributions (both deductible and undeducted) in excess of this total contribution limit. The tax would be payable by the member. (This penalty tax would apply in addition to the proposed additional 30% tax applicable on deductible contributions in excess of the deductible contribution limit.)	4.4.2 and 4.5.1
8.3	Requirements to refund excessive undeducted contributions should be removed. The additional 20% penalty tax will strongly discourage excessive contributions. We consider that the penalty tax is such that there would no longer be a need to require any undeducted contributions (or deductible contributions) to be refunded, further simplifying the process.	4.4.2 and 4.5.1

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APPENDIX 2: Previous Submissions made by Mercer Human Resource Consulting

Submission	Date
Submission Overview	13 July 2006
Submission No.1 – Undeducted Contributions	13 July 2006

13 July 2006

A Plan to Simplify and Streamline Superannuation

Submission 2: Issues relating to the proposed limit on deductible contributions

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1

General Policy – Imposition of an Annual Limit on Deductible Contributions

We understand that the Government wishes to limit the amount of deductible contributions (generally made by an employer or self-employed person) that will be taxed at the concessional rate of 15%. It is proposed that this limit will be \$50,000 for all members regardless of age.

In view of the proposal to remove the Reasonable Benefit Limits that restrict the amount of benefits that are concessionally taxed, we agree that some form of limit on deductible contributions may be necessary to prevent excessive use of the superannuation arrangements by highly paid or wealthy individuals.

If a limit is to be imposed, then the Government needs to ensure that the monitoring system is workable and can be administered at relatively low cost, particularly as the limit is only likely to impact on a very small percentage of fund members. Despite this expected narrow focus, the costs of administration will be spread across all members.

The Government therefore needs to ensure that administrative requirements and hence costs are kept to a minimum.

However, we are concerned that the proposed mechanisms will be complex and expensive to administer. The proposed process appears very similar to the process adopted for the superannuation surcharge. This process proved to be totally unsatisfactory and resulted in huge ongoing administration costs for superannuation funds and for the ATO. It is critical that lessons be learned from the surcharge so that any new system does not suffer from the same shortcomings.

In this report we have considered:

- the mechanics of the old surcharge to highlight the major problems; and
- approaches which would minimise these problems.

Problems with Surcharge

There were many problems arising from surcharge. If a similar administrative system is to be reintroduced to monitor and apply the proposed contribution limits, then it is important to analyse these problems to determine what adjustments to the system are required to reduce costs and ease the administrative burden for trustees of superannuation funds and the ATO.

The problems included:

- poorly drafted legislation which led to:
 - significant doubts about its legality;
 - considerable doubts as to whether the legislation was consistent with the Government's intent;
 - the need to make significant changes to the legislation over time as further problems or perceived problems arose;
- the complexities of calculating notional surchargeable contributions (defined benefit funds) and allocated surplus amounts (accumulation arrangements);
- the addition of complex reporting requirements which had to be installed in systems already overloaded due to regular legislative changes;
- legislative and system issues which often led to errors in reporting;
- inflexibility of ATO systems to easily handle corrections;
- confusion in relation to the treatment of self-employed members - in particular the need to report deductible contributions for self-employed members differently to deductible contributions for other members;
- long delays in receiving surcharge assessments from the ATO;
- problems arising where the member had already left the fund when the assessment was received;
- the inability of the fund (on whom the assessment was levied) to actually verify the assessment as it relied on information not available to the trustee;
- a dubious concept of imposing a tax on one entity (the superannuation fund) based on the income of another entity (the member);
- many members were aggrieved that a surcharge was imposed on benefits that the member never received. This occurred in accumulation arrangements (where the surcharge was payable on contributions that were not fully vested) as well as defined benefit funds where the surchargeable contributions often bore no relationship to the eventual benefit payable;
- funds paid the assessment but the member was unaware until months later that this had occurred (whilst the ATO was supposed to provide a copy of the assessment to the member, it appears that this did not always occur);
- long delays in processing meant that members had to pay previous years' surcharge assessments from after tax income if they had already cashed their superannuation benefit;
- surcharge was payable in some cases merely because the member had not supplied a Tax File Number;
- for those on higher incomes, it was generally not possible to avoid the surcharge. For those whose adjusted taxable income exceeded the surcharge threshold,

surcharge applied to all taxable contributions, including compulsory SG contributions;

- the highly complex calculation process was not understood by members;
- there were inequities (both real and perceived) between the members of constitutionally protected schemes, other “untaxed” schemes and private sector schemes.

We note that the Government’s new proposals will mean that some of the above issues will not apply or will apply to a more limited extent. The structure of the new system will also result in far less members being affected than were affected under surcharge.

The proposed limits under the new system will enable all but a few members to avoid being impacted by the proposed penalty provisions. Most individuals should be able to ensure that contributions are within the limits. However, this will not always be the case – consider a person who is serving as a director on six Boards and who receives a director’s fee of \$100,000 from each. As each employer is required to contribute 9%, total deductible contributions will exceed \$50,000.

Another example where breaching the limit cannot be avoided is an executive or senior manager who is a member of a defined benefit fund.

However such cases are expected to be in the minority. They will be even less common if the limit is increased, as recommended in Section 3.

Thus individuals will generally be able to avoid the penalty tax. Even where not avoided, the removal of taxes on benefits from age 60 will still mean that saving for retirement through superannuation is tax effective.

The significant problems that remain are likely to be:

- complexities in calculating notional contributions for defined benefit funds;
- inequities in relation to notional contributions in a defined benefit fund;
- complexities in calculating allocated surplus amounts for accumulation arrangements;
- long delays in ATO processing (these should not be as great as the ATO will not have to match superannuation fund reports with a member’s tax return but could still be extensive);
- members being unaware of the ATO “assessment” with the additional tax arguably levied on a fund where it would be more reasonable for it to be levied on the member;
- difficulties where requests for additional tax or contribution refunds are issued to funds that no longer retain the contributions on which the additional tax etc was based;
- the additional tax applying merely because the member has not supplied a Tax File Number;
- inequities between the members of “untaxed” schemes and private sector schemes.

Recommendation 1.1: If the Government proceeds with its proposed model, further consideration is necessary to minimise the problems (previously seen in relation to surcharge).

In Section 2, we consider some specific ways of minimising the administrative burden.

2

Ways of Streamlining the Proposed System

Legislative drafting

As indicated in Section 1, the surcharge legislation was poorly drafted. We can understand that it was no easy task to draft legislation that met the Government's requirements whilst at the same time trying to minimise loopholes.

However, the introduction of new terminology which had to be interpreted using the definitions (rather than the words taking their normal meaning) added unnecessary confusion.

Recommendation 2.1: In order to meet the Government's aim of simplification, the legislative requirements must be enacted using plain English and using words which are clearly understood.

Notional contributions for defined benefit funds

The required methodology for determining notional contributions under the surcharge legislation was extremely complex and resulted in many inequities and excessive compliance costs.

The Government needs to ensure that any new requirements are far simpler and cost effective. We will make further comments on the methodology of determining notional contributions in a later submission.

Recommendation 2.2: The method for determining notional contributions for defined benefit funds must be considerably simpler than the methodology required for surcharge purposes.

Allocated surplus amounts for accumulation arrangements

Whilst not specifically mentioned in the Government's proposals, we assume that there may also be a requirement to treat allocations from surplus in accumulation arrangements in the same manner as a contribution.

This requirement, under the surcharge legislation was also highly complex and cost inefficient. We will also make further comments on this methodology in a later submission.

Recommendation 2.3: Any requirement to treat allocated surplus amounts as deductible contributions must be much simpler than the methodology required for surcharge purposes.

Deduction of tax

We understand that the Government's intention is that the ATO will monitor whether a person has exceeded the deductible contribution limit and issue an assessment for the additional 30% tax on any excess. Under this approach, funds would not need to monitor the level of contributions received and nor would they be liable to automatically deduct the higher tax on any excess.

In our view, this is a reasonable approach. We would be very concerned if funds were expected to monitor the level of contributions and apply different tax rates to different layers of contribution.

Even if funds were required to monitor contribution levels and deduct differing levels of tax, members who wish to exceed the limit could make a series of smaller contributions to more than one fund.

Requiring funds to monitor the limit will not remove the requirement for the ATO to combine reports from all funds and determine whether the limit has been exceeded. In effect, this would result in duplication of effort. It would therefore seem reasonable that only the ATO be involved in the monitoring process.

A similar, but potentially more complex, situation arises in respect of members who have not supplied their TFN to the fund. If a fund is required to deduct tax on contributions in excess of \$1,000, it may then be necessary for the fund to claim a tax refund and process this to the member's account later in the year once a TFN has been supplied. This would appear cumbersome and costly. It is a totally different scenario to the normal situation where a member does not supply a TFN to say, an employer. The member can effectively reclaim the extra tax paid when submitting a tax return. This is different from the situation under the Government's superannuation proposals where a third party (ie the fund) would have to recoup the tax from the ATO (once it obtains the member's TFN) and recredit it to the member's account. In some cases, this will not even be possible as the member may have transferred to another fund before the additional tax is refunded.

Further, once the ATO analyses reports from all funds, their matching process may indicate that the TFN has been provided to some but not all of the member's superannuation funds. Again it would presumably be necessary to issue a refund of tax (which could be further complicated if the fund which deducted the tax has already transferred the benefit to another fund).

Defined benefit funds would have even greater difficulties in deducting tax at the differential rates as the notional contributions may not be known until after the end of the year (particularly if a complex method such as that used for surcharge is required).

Recommendation 2.4: All monitoring of the limits should be conducted by the ATO. Funds would not be required to determine whether the deductible contribution limit of \$50,000 pa (or \$1,000 for members who have not supplied a TFN) has been exceeded and would only deduct 15% contribution tax.

Assessing additional tax

To minimise the administrative costs and problems that arose under the surcharge, we believe that it would be far more efficient for the ATO to deal directly with the member to:

- ensure that there have been no errors in reporting;
- make the member aware that an additional tax has been imposed;
- discourage further excesses; and
- ascertain the TFN where applicable.

This would ensure that any assessment issued is actually correct. We would expect that where the contribution limits have been exceeded, the member is likely to be a high income or wealthy individual who uses a tax agent to deal with their tax affairs. Thus we would expect that the ATO would generally be dealing with the tax agent. The main exception might be where the assessment is only arising because a TFN has not been supplied).

This approach would also enable the member to choose the fund from which the additional tax should come.

However, we consider that it would be even more efficient if the ATO were to issue the assessment *to the member* rather than any fund. The member would be able to pay the additional tax directly or could take the assessment to a superannuation fund which would pay the tax on the member's behalf.

This approach would effectively provide the member with a choice of which fund should pay the tax. It would ensure that the tax payment is made without the difficulties which occurred under surcharge where members have changed funds.

Recommendation 2.5: The ATO should liaise directly with the member (or the member's tax agent) to ensure that any assessment is correct and then issue the assessment to the member.

Recommendation 2.6: The member would be able to request any relevant superannuation fund to pay the tax on his/her behalf.

Recommendation 2.7: A fall-back position may be required where the ATO can actually issue an assessment on a relevant superannuation fund if the ATO has been unable to obtain a response from the member.

Tax File Numbers

As indicated in Submission No. 1, the Government's proposed system would work far better if superannuation funds are provided with members' TFNs.

To date it has not been compulsory with many members deliberately not providing their TFN to slow down the surcharge assessment process (ie those who knew that they were subject to the highest rate of surcharge). However many other members have, due to inertia, not supplied a TFN. Many of these were not subject to surcharge because their contributions were below the Surcharge Contributions Threshold.

These members will be significantly impacted by the new proposals unless a TFN is now provided.

Superannuation funds can only do so much to encourage members to supply a TFN.

We believe that the Government needs to take further action to assist the process of collecting TFNs. If this is not done, we are concerned that an administrative nightmare will result as well as a considerable public backlash when they realise that a 45% tax has been (or is about to be) deducted from contributions.

As indicated in Submission No. 1, the current TFN form completed by new employees enables the member to tick a box indicating that the TFN can be passed on to a superannuation fund. However, we are aware of trustees who consider that they should not accept TFNs from employers as it is not possible to ascertain whether the TFN was provided legally. If provision was mandatory, trustees would be able to readily accept the TFN from the employer.

Funds still attempt to obtain the TFN directly from the member but often without success. We are aware of funds in which up to 30% of members have not supplied a TFN. This would generally be in relation to members of standard employer sponsored funds where there is no need for new members to sign an application form.

Recommendation 2.8: TFN legislation should be amended to make it mandatory for employers to pass on employees' TFNs (where known) to their relevant superannuation fund (unless there is a positive direction by the employee to the contrary).

Recommendation 2.9: The ATO should consider writing to all members who have not supplied a TFN to their fund to encourage them to do so. (The ATO mail-out could be based on the latest surcharge reporting.)

Transitional issues

For the purposes of reporting contributions for surcharge and co-contributions, funds have been required to report contributions to the ATO for those members still in the fund as at 30 June each year. Reporting to the ATO is also required where all benefits have been cashed.

For members who transfer to another fund during the year, reporting is to the rollover fund, rather than the ATO.

Assuming a similar process is to apply from 1 July 2007, a significant difficulty is likely to arise in respect of rollovers as funds may not have time to implement new procedures in time to report the required information to rollover funds early in the year.

We expect that defined benefit funds will have the greatest difficulty as new methodologies must be developed to determine notional contributions. If the new requirements are not finalised until close to June 2007, early reporting to rollover funds will not be possible.

It may therefore be necessary for the Government to accept that this is just an initial teething problem and ignore notional contributions in respect of members who have rolled over in the period up to say 30 September 2007. This is unlikely to provide a significant opportunity for members to abuse the system but would provide considerable relief from additional administrative costs for funds.

Recommendation 2.10: As full details of reporting requirements and the calculation process for notional contributions are unlikely to be available until shortly before 1 July 2007, it is unlikely that funds will be able to modify systems in time to report these details to rollover funds in respect of rollovers occurring shortly after 1 July 2007. It may therefore be necessary to ignore notional contributions in respect of rollovers for a short period after that date.

3**Is the Proposed Limit Appropriate?**

On the assumption that the change to the limits for deductible contributions is implemented, there are arguments for a higher limit than \$50,000.

Reasons for a higher limit

The proposed limit is approximately half the existing deductible limit for individuals over the age of 50. The new limit will therefore reduce considerably the ability of those approaching retirement to increase their retirement savings.

Even taking into account the proposed transitional arrangements for those over 50, some individuals may be concerned that they do not have sufficient time to build up their retirement benefits. People who have had periods out of the workforce may have been planning to make catch up deductible contributions later in life. Many have been restricted by the current age based tax deductible limits and have not been able to contribute even \$50,000 in the past. They may have been hoping to boost their superannuation savings by contributing significantly more after reaching age 50, only to find that they will now be subject to, effectively, a \$50,000 limit. Older people also have a higher savings capacity. However, designing rules around catch-up contributions would be very complex and hence it would be simpler to allow a higher limit.

A limit for couples

The proposed limits operate on an individual basis. No consideration is given to whether the person is single or part of a couple. In broad terms, a single-income couple will only be able to make concessional tax contributions of \$50,000 pa, the same as a single person. Yet a couple needs a higher level of retirement savings than a single person.

Even if a couple is made up of a low and a high income earner, the low earner is unlikely to be able to make significant deductible contributions due to limitations on earned income. It may be considered more equitable if couples could combine their limit with one party being able to utilise any unused part of their partner's limit.

Whilst this argument has some appeal, it would add further complexity to the proposals. However this complexity would be reduced if the ATO deals with individuals who exceed the limit, not superannuation funds. It is also noted that many of these individuals would have tax agents who would be aware of the TFNs of both partners.

Increasing the general limit from \$50,000 to \$100,000 would enable a higher proportion of couples to contribute a combined level of \$100,000 without adding to the complexity.

Defined benefit members

A higher limit would also solve the problems of the many members (potentially thousands) of defined benefit schemes who will breach the limit by merely being a member of such schemes. These members include senior employees in both the private and public sectors.

Under 40's

Many of those under age 40, or even age 50 have little ability to contribute significant amounts to their superannuation.

Many younger people are studying well into their twenties after which they may need to repay significant HECS debts.

Younger people are also deferring their careers and taking the opportunity to travel.

Even after moving into the work force, younger people have other priorities such as paying off a mortgage and raising a family.

These issues, together with the likelihood of younger people earning lower salaries than older people on average, will mean that the under 40's will generally be unable to make significant superannuation contributions. The removal of the age based deductible limits will therefore have little impact on this age group.

With the trend to have children later in life, it is also unlikely that many of these younger people will be able to make catch up contributions during their 40's. It is only once they reach age 50 or beyond that it may become possible to make significant contributions. Yet it is for this age group that the Government's proposals effectively cut in half the current "limits" from the age based deductible limit of just over \$100,000 to the proposed concessional limit of \$50,000.

Women

Many women have significant periods out of the work force, or accept part-time work whilst raising a family. On returning to work to restart their career after the child care years, they will also find themselves limited, during their most productive years from a paid employment perspective, to the proposed cap of approximately half the current effective limit.

We also note that if a higher limit is imposed, it will impact on even fewer members and more approximate methods of imposing the limit could be considered.

Recommendation 3.1: A higher limit than \$50,000 pa should apply. To be more consistent with current age based deductible limits and to allow couples more ability to increase their retirement benefits, a limit of \$100,000 pa should apply.

Indexation of limits

The proposal does not specify any indexation of the contribution limits. We recommend that these limits be indexed in line with Average Weekly Ordinary Time Earnings. In line with the desire for simplification, we suggest that the indexed limits be rounded each year to the nearer \$1,000. The actual calculation of the updated figures each year could continue to be based on unrounded numbers (as we have suggested for indexing the undeducted contribution limit in Section 1 of Submission No. 1).

If transitional limits apply, these limits should also be indexed as members over age 50 were expecting to be able to contribute at indexed rates under the current rules.

Recommendation 3.2: The concessionally taxed limit (and any transitional limits) should be indexed in line with movements in AWOTE.

Consistent with our recommendation for indexation of the undeducted contribution limit in Submission No. 1, it would be simpler if any indexed limits were rounded to the nearer \$1,000.

Recommendation 3.3: Any indexed values should be rounded to the nearer \$1,000. It would also be preferable for a fixed relationship to be established with the limit for undeducted contributions (or a combined limit as per Recommendation 8.2). For example the undeducted contribution limit, except during any transitional period, could be set at 1.5 times the concessionally taxed limit for deductible contributions – assuming this limit is increased to \$100,000.

**4**

Transitional Arrangements for Individuals Aged 50 and Over

The Government has announced that transitional arrangements for the deductible contribution limit will apply to those over age 50 up to 30 June 2012.

The Fact Sheet on the Government's "simplersuper" website indicates that those who turn age 50 during the transitional period will be able to contribute up to \$100,000 in the year they turn 50 and in subsequent years during the transition period.

We consider that this is an appropriate approach. It would mean that contributions made during the year a person turns 50 would be subject to the transitional limit irrespective of whether the contribution was made before or after the person reached age 50.

We would be concerned if the final rules imposed further restrictions (for example, if the rules provided that the transitional arrangements would not apply to a member who would have turned 50 during the year but died before their 50th birthday).

Our concern in relation to this matter is based on the rules for the current age based limits for tax deductibility purposes. These rules require a calculation of the person's age as at the date the last contribution was made during the year. Such a rule has proved difficult to explain to employers and members and would appear to be unnecessarily complex. A much simpler rule should be applied here with the transitional limit applying to all contributions made in the year in which the person attained or would have attained their 50th birthday.

Recommendation 4.1: The \$100,000 transitional limit applicable for any year (up to 30 June 2012) should not only apply to all individuals who have either reached age 50 in that year or an earlier year (as clarified in the Government's Fact Sheet) but also to individuals who would have reached age 50 in that year (eg those who die before reaching age 50).

This will allow a smooth transition rather than an abrupt transition. An individual who turns 50 in 2007/08 would be able to contribute \$100,000 per annum for 5 years, someone turning 49 would be able to contribute \$100,000 per annum for 4 years, etc, and someone turning 45 in 2007/08 would be subject to the new limit throughout.

This approach will also enable those who will turn 50 during the year to contribute on a regular basis throughout the year rather than effectively needing to defer contributions until after their 50th birthday.

We note that if our earlier recommendation of increasing the limit to \$100,000 pa is adopted, there would be no need for transitional measures.

5**Non 30 June Company Tax Years**

The existing deductible limits specify the maximum amount an employer can claim as a tax deduction, and are therefore based on the employer's tax year. This may not be the year ending 30 June. The proposed rules will, however, allow employers to claim a tax deduction for all contributions for eligible employees. This change is welcomed.

The proposed new limit will be imposed on individuals and therefore will presumably be based on the year ending 30 June.

Whilst the changeover from the current to the proposed system is clear where the employer's tax year ends on 30 June, there is some uncertainty in relation to employers with tax years ending on other dates. The Government needs to clearly indicate how this change will impact on such employers in the switch from one basis to the other in 2007.

Two examples highlight this uncertainty.

Example 1: Consider an employer with a tax year ending 31 March.

The employer makes a contribution of \$60,000 in May 2007 (say, in lieu of a bonus) in respect of a 48-year-old. The contribution is in excess of the age-based deductible limit that applies for the 2006/07 tax year.

As the contribution is made in the employer's 2007/2008 tax year, will the employer be entitled to a deduction for the whole contribution, even though it is made before 1 July 2007?

Or will some form of age based contribution limit continue to apply up to 30 June 2007 for these early balancing employers?

Example 2: Consider an employer with a tax year ending 30 September.

The employer makes a contribution of \$60,000 in August 2007 in respect of a 48-year-old. Again, the contribution is in excess of the age-based deductible limit that applies for the 2006/2007 tax year.

As the contribution is made during the employer's 2006/2007 tax year, albeit after 1 July 2007, will the age based limit continue to apply? (This would seem particularly unfair as the contribution in excess of \$50,000 would also be subject to the additional 30% contribution tax.)

Or would the employer be entitled to a deduction for the whole contribution as it was made after 1 July 2007? If so, how are contributions made before 1 July 2007 to be treated in relation to the employer's age based deductible limit.

We consider that it is important that a simple methodology should be adopted which can readily be explained to employers and employees. As this is a once off transitional problem, simplicity and apparent fairness should override more technical considerations.

Recommendation 5.1: For employers with a tax year that ends on a date earlier than 30 June 2007, all employer contributions made during the employer's 2007/2008 year should be tax deductible.

Recommendation 5.2: For employers with a tax year that ends on a date after 30 June 2007, all employer contributions made after 30 June 2007 should be tax deductible with only contributions made before 1 July 2007 being subject to the age based limit.

In each case, only contributions made on or after 1 July 2007 would be taken into account for the purposes of the member's concessional tax deductible contribution limit.

6

Deductibility of Employer Contributions

Currently employers cannot claim a tax deduction for contributions in respect of eligible employees aged over 70 (except for contributions required by an industrial award, determination or notional agreement preserving State awards).

In other words, employers are currently not eligible to claim a tax deduction for superannuation contributions required under an Australian Workplace Agreement (or certain other agreements) for an employee over age 70. This appears totally unreasonable.

Eligible employees are limited to those who are current employees of the employer engaged in producing assessable income of the employer.

We support the proposal to extend tax deductibility to contributions in respect of eligible employees aged up to 75.

However this would still require employers to treat workers over age 75 differently from those under age 70. This appears to be discriminatory on the grounds of age and, bearing in mind the small number of people in the workforce at these ages, we consider that the age limit should be removed. At the very least, contributions required under AWA's etc should be tax deductible.

Recommendation 6.1: As indicated in the Government's proposals, employers should be able to claim a tax deduction in respect of all eligible employees up to age 75; although we consider that the age limit should be removed entirely.

We also believe that there is now the opportunity to make additional changes to the tax deductibility rules. For example, we recommend that tax deductibility be extended to contributions in respect of **former** employees as well as current employees, at least in certain circumstances.

Whilst less common today, some employers have, for many years, “promised” to provide retired former employees with a lifetime pension. These pensions were provided through defined benefit funds.

In most cases, the intention was that these pensions would be fully funded by retirement age. However, with increasing life expectancy and, from time to time, investment returns that do not match original expectations, it is possible that these pensions may become partially unfunded at some point, requiring additional employer contributions.

Under the current rules, the employer is able to claim a tax deduction for contributions to its defined benefit fund up to the sum of the age based limits for its defined benefit employees. This generally enables some funding of any deficit resulting from pensions provided that the funding for existing defined benefit employees is less than the maximum allowed.

With the proposed removal of the age based deductible limits, there is a risk, depending on the legislative wording, that it will no longer be possible for an employer to claim a deduction in respect of contributions necessary to fund a deficit in relation to pensioners.

Where there are existing employees who are entitled to defined benefits, it may be difficult to ascertain the contributions in respect of existing employees and the contributions required in respect of pensioners. This would result in an immediate practical problem of how contributions are notionally apportioned between the two groups for tax deductibility purposes.

However, many of these employers are no longer willing to continue providing defined benefits, at least for new employees, and at some point, the only remaining defined benefit members will be pensioners. In such an environment, unless the legislation is amended, it would appear that the employer may not be able to claim a tax deduction in respect of contributions necessary to remove a deficit in the fund. This will put the continued funding of these pensions at risk.

The pensions will generally be paid to a former employee or the dependants of a former employee. In some cases there may not have been a direct employment relationship between the employer and the pensioner – rather the employer may have taken over the funding responsibilities of another employer following a corporate takeover with the pensioner having previously been employed by the acquired company. Tax deductibility needs to be extended to cover all of these pensioners.

To better protect the security of pension benefits, employers should be able to obtain a tax deduction in respect of all contributions to a defined benefit fund - at least where the actuary considers that such contributions should be made.

We note that there is little opportunity to “reort” such a system. Other regulations prohibit the establishment of new defined benefit funds unless there at least 50 defined benefit members. This would prevent SMSFs turning their funds into a defined benefit fund so that greater deductible contributions can be made on the concessionally taxed basis.

Whilst existing defined benefit funds can continue with less than 50 members (without admitting new members), it would be possible to add further controls by requiring actuarial certification of contributions for this purpose.

Recommendation 6.2: All employer contributions to a defined benefit fund (including for pensioners) should be tax deductible so that employers can continue to ensure the security of pension benefits.

**7****What Should Not Be Included in Any Limit?***Transfers from overseas funds*

When a fund receives a transfer amount from an overseas “retirement” fund, part of the transfer is treated as an undeducted contribution. The balance is treated as a taxable contribution.

In Submission No. 1 we argued that the undeducted contribution component of amounts transferred from such overseas funds should not be taken into account for the purposes of the limit on undeducted contributions.

Likewise, we argue that the balance of such transfer amounts should not be included for the purposes of the deductible contribution limit.

This taxable portion of transfer amounts actually relates to the investment growth on the transfer value since the person became an Australian resident and is hence unrelated to contributions. As such it should not be tested against the proposed limits.

If it is included, this would significantly restrict the effectiveness of transferring these benefits into an Australian fund with the likelihood that they would be retained overseas.

We are pleased to note that Section 4.6.1 of the Government’s discussion paper indicates that the taxable portion will continue to be taxed at the flat 15% rate.

However, the discussion paper does not make it clear that such taxable contributions would not still be counted for the purposes of the limit – eg if the taxable component of an international transfer is \$60,000, this amount would be subject to only 15% tax but this may be of limited value if all other deductible contributions are considered to be in excess of the limit.

Recommendation 7.1: Amounts transferred from overseas retirement plans should not be included with deductible contributions for the purposes of the proposed test.

8**Excess Contributions**

Under the proposed system, any deductible contributions in excess of \$50,000 pa are subject to a higher rate of tax but can still be retained in the superannuation system. This is a different approach to that proposed for undeducted contributions where any excess over the \$150,000 pa limit must be refunded.

These different approaches are likely to lead to anomalies and the opportunity for some members to effectively circumvent the new limit on undeducted contributions.

This is particularly the case for those with very high incomes. Consider an individual with a taxable income of \$1 million pa. Via a salary sacrifice arrangement with an employer, deductible contributions of \$550,000 are made during a year. The employer is eligible for a full tax deduction.

The additional 30% contribution tax is applied to the contributions in excess of \$50,000 resulting in a total tax of 45% on these excess contributions. In this example, the tax on the additional contributions is equal to the tax that would have been payable if the person had received the excess \$500,000 as salary rather than as a superannuation contribution. In other words the effect of the excess contribution is little different to the person making an undeducted contribution of \$275,000 (= \$500,000 less 45% tax). However the person has not been required to pay the Medicare levy resulting in a saving of \$7,500.

This creates an anomaly in that this person would have been restricted to an undeducted contribution of \$150,000. In other words, the proposed rules allow those with very high incomes to circumvent the limit on undeducted contributions. (For those on lower incomes, the 45% contribution tax would act as a discouragement as it would be greater than the marginal tax rate.)

We consider that the proposed rules should be modified to remove this anomaly so that high income persons are unable to achieve what lower income persons are restricted from doing.

One approach to remove the anomaly would be to require that any deductible contributions in excess of the annual (\$50,000) limit be added to any undeducted contributions and compared with the \$150,000 undeducted contribution limit. Any combined excess could then be refunded (or assessed for penalty tax under our preferred alternative approach).

However this does not really solve the problem by itself. For example, it could potentially lead to significant contributions made in order to avoid the Medicare or other future levies.

Further, any requirement for the contribution to be refunded, would trigger the need for the fund to reclaim (from the ATO) contribution tax already paid (either at the 15% or 45% level). The ATO would then potentially have to issue a further assessment to the member to collect the appropriate tax and Medicare Levy. This would appear overly complex.

It could also be argued that only 85% or perhaps 55% of any excess deductible contributions should be added to undeducted contributions and compared against the \$150,000 undeducted contribution limit. This lower amount would take into account the fact that contribution tax of 15% or 45% would have applied. Such adjustments, although logical, add further complexity.

The introduction of an averaging approach for undeducted contributions also makes such an approach more complex.

A simpler approach should be adopted. In our view, a penalty should be applied *on the member* to restrict extreme contributions as follows.

- Deductible contributions would be taxed by the fund at 15%;
- The ATO would assess an additional 30% tax on deductible contributions in excess of \$50,000 pa (or the relevant transitional limit);
- The additional tax would be payable by the member;
- The averaging proposed for undeducted contributions would be dropped in favour of higher transitional limits;
- A further penalty tax of 20% would be assessed by the ATO in respect of total contributions in excess of the combined deductible and undeducted contribution limit;
- The additional tax would be payable by the member;
- No deductible contributions or undeducted contributions would be refunded;
- The member could request a relevant superannuation fund to pay the additional tax on his/her behalf.

In the above example, assuming that no undeducted contributions had been made: an amount of \$500,000 (\$550,000 - \$50,000) would be subject to the additional 30% contribution tax (payable by the member); \$350,000 (\$550,000 - \$200,000) would be subject to a further 20% penalty tax (payable by the member).

If the member had also made a \$100,000 undeducted contribution, the total contributions made would have been \$650,000. The additional 20% penalty would then apply to the total excess of \$450,000.

The 20% penalty would more than offset the savings in the Medicare levy and should discourage the making of contributions in excess of the limits.

Recommendation 8.1: The Government's proposals involve different mechanisms for restricting deductible and undeducted contributions. The different mechanisms restrict individuals from making excess undeducted contributions however high income earners can make unlimited excessive deductible contributions on a tax effective basis. This anomaly needs to be removed.

Recommendation 8.2: To remove the anomaly, the limit on undeducted contributions should be replaced with a combined limit equal to the sum of the deductible contribution limit and the undeducted limit. A 20% penalty tax, assessed by the ATO, should be applied in respect of all contributions (both deductible and undeducted) in excess of this total contribution limit. The tax would be payable by the member. (This penalty tax would apply in addition to the proposed additional 30% tax applicable on deductible contributions in excess of the deductible contribution limit.)

Recommendation 8.3: Requirements to refund excessive undeducted contributions should be removed. The additional 20% penalty tax will strongly discourage excessive contributions. We consider that the penalty tax is such that there would no longer be a need to require any undeducted contributions (or deductible contributions) to be refunded, further simplifying the process.

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