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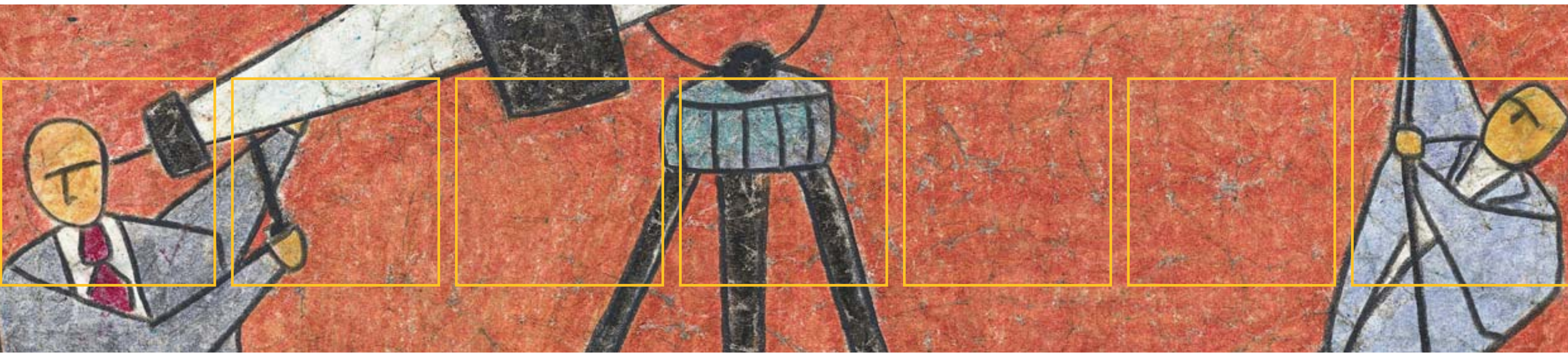

2006 Federal Budget proposed changes

Implications for employers, working Australians and the superannuation industry

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2006 Federal Budget proposed changes

The Federal Government has announced the most significant changes to Australian superannuation in 20 years, opening up new options for those approaching retirement, presenting new challenges for employers and heralding broad-ranging changes for the superannuation industry.

Put simply, the proposed changes will simplify superannuation and retirement incomes for individuals aged 60 or over and encourage an unprecedented level of saving through superannuation.

These changes will have long-term effects on the Australian community through

- the way Australians save and their view of investing in superannuation
- changing the focus of personal financial education and advice
- the relationship between employers and their older employees
- changing attitudes towards the transition from work to retirement
- different methods of financing retirement
- the operations of the Australian superannuation industry.

Mercer welcomes the proposals, which will have a positive impact on most people. We do note, however, that time will be needed to plan for an efficient and equitable implementation of some of the initiatives. Also, we note that some aspects of the proposals are yet to be resolved.

Mercer intends to contribute to the resolution of these issues by making submissions to Treasury during the three-month consultation period.

Good news for super

Tax-free benefits

Mercer welcomes the Government's announcement that all lump sum or pension payments paid from a taxed source to individuals aged 60 or over will be tax free after 1 July 2007. Furthermore, these payments will not need to be reported by the individuals or the superannuation fund.

Pension rules have also been simplified to provide retirees with much greater flexibility.

> Mercer believes that these changes represent considerable simplification of superannuation and retirement incomes for individuals aged 60 or over.

The taxation of superannuation has been considerably simplified. With the abolition of taxes after age 60, the only taxes paid by most Australians on their superannuation will be the tax paid by the funds in respect of deductible contributions and investment income.
All deductible contributions (whether they be employer contributions, salary sacrifice contributions or from the self-employed) will only be taxed at 15%, providing they are within the prescribed limits (see below).

Mercer believes that these changes will encourage a higher level of savings as superannuation is now clearly more attractive for workers with a marginal tax rate of 30% or higher. From a societal perspective, our traditional investment choices will be turned around, with saving via superannuation becoming an increasingly popular vehicle for wealth accumulation.

The increased attractiveness of superannuation, together with the planned contribution limits, means that financial education and advice for individuals of all ages is now highly desirable.

Regulations related to contributions by the self-employed will be simplified. Contributions will be fully deductible, subject to the prescribed limits. Furthermore, the self-employed will have access to the co-contribution arrangements from 1 July 2007 for their undeducted contributions.

These changes will encourage a higher level of super savings from the self-employed.

Considerable flexibility has been introduced to the payment of retirement benefits from superannuation funds. Mercer endorses the abolition of both the work test and the requirement that benefits must be paid out from age 75.

There are currently a range of income stream products available with different rules and conditions. The introduction of a single standard for pensions with a single minimum drawdown requirement is a welcome change.

Transition to retirement

Transition to retirement pensions have also been simplified, allowing no more than 10% of the account balance to be withdrawn in any year.

What is transition to retirement?

In February 2004 the Federal Government announced changes to the rules which regulate the way Australians build and withdraw their super benefits. The rules are designed to help employees stay in the workforce longer and make a gradual transition to retirement easier.

Mercer is currently producing a whitepaper for Australian employers on transition to retirement. Scheduled for publication in the second half of 2006, Mercer's paper will look at the global and local experience. Importantly, it will also examine the various human resources, employee communication, investment and financial planning perspectives which will impact organisations and workers in the future.

These changes simplify financial planning decisions for retirees whilst also offering them considerable flexibility in their retirement years.

Transition to retirement is likely to become more popular. The changes are also likely to increase the labour force participation rate after age 55 which will assist Australia in managing the impending labour shortages.

Mercer believes that workforce planning by employers is now more important than ever. The changing demographics of the Australian workforce means that organisations will need to consider carefully their workforce strategies to address the needs of their ageing workforce, and ensure that older workers remain motivated and productive.

Employers will need to consider:

- Strategies and policies to support transition to retirement, making this a viable and attractive option for their employees.
- Effective succession planning, so the skills and corporate knowledge held by older workers are successfully transferred to employees who will remain in the organisation.
- Effective communication with its employees.

Employers may consider surveying their workforce to ensure they understand their employees' intentions to retire, to assist with strategic planning.

- Does the employer know its employees' intentions to retire, so it can plan effectively?
- Has it surveyed its workforce to see what is motivating its older workers?
- Has it communicated policies and strategies, so that employees understand how the employer is responding to these workforce issues?

Employers should demonstrate the importance of this demographic by engaging them in conversations that recognise their status and value to the organisation and then look at options for continuing their involvement in the workplace.

Employers may consider:

- Offering access to services like investment and financial planning advice as part of their workforce package. Employees need to be financially educated consumers and need to be accountable for managing their personal wealth and security.
- Finding a way to assist older employees to deal with health issues or illnesses, care for elderly parents or grandchildren and access to health services.
- Recognising the interests of older employees and offering flexible work arrangements such as part-time work.
- Promoting the idea that the transition to retirement stage of a person's career involves coaching and mentoring. This means using the older worker's expertise to ensure the next generation is well equipped with appropriate skills and corporate knowledge to help the organisation achieve its business goals.

Changes to marginal tax rates and thresholds mean that salary packaging will become less effective for a significant number of employees who now benefit. To remain able to attract and retain the best talent, employers will need to consider their total reward offering (careers, remuneration and other benefits), and ensure that they remain attractive to both existing and potential employees.

Challenges for funds

Limits on deductible contributions

The Government has introduced new limits on deductible contributions of $50,000 per person per year, with transitional limits to apply until 2011/12. It is planned that the ATO will assess whether an individual's limit has been breached from information provided by superannuation funds. Should the limit be exceeded, an additional tax of 30% will be levied on the excessive contributions in the most practical fund. The Government anticipates "that there would be few instances where this would be necessary."

This approach creates major difficulties for funded defined benefit schemes as superannuation benefits accruing to an individual in a year will require the calculation of a notional contribution for each member.

The Government has also announced that the additional tax of 30% would also apply on taxable contributions in excess of $1000 per annum if a Tax File Number has not been quoted.

Mercer believes that these requirements are complex and will significantly increase the costs for all superannuation funds and therefore all members. They are reminiscent of the surcharge administration. This additional cost and complexity is introduced to limit the level of superannuation savings for a very small percentage of the population.

Further, the use of notional contributions for defined benefit members will inevitably lead to inequity and further complexity.

Limits on undeducted contributions

The Government has also announced a planned cap of $150,000 per person per year on undeducted contributions, with a three-year average. Certain exemptions would be available to this cap, such as the CGT-exempt component from the sale of a small business. Excessive contributions would be returned to the individual. However investment earnings on

these excessive contributions would be taxed at 45%, which is likely to be very difficult to implement.

Again Mercer believes that these requirements are very complex and will significantly increase the costs for all superannuation funds and therefore all members. There are also anomalies introduced, given that exemptions will be permitted.

Mercer will be making submissions to Treasury suggesting simplification of the above process whilst maintaining the general intent of the proposed limits.

Mercer recommends that any contribution limits that may be introduced should be indexed.

The industry's need for clarity

Many of the positive and simplifying changes will commence on 1 July 2007. However, some of the limitations (e.g. undeducted contributions) apply from 9 May 2006. Inevitably, this means that some individuals at or near retirement are uncertain of the way forward in the short term. The Government's new plan has not yet been confirmed but restrictions have been placed on individuals' actions following the Budget. It is also unclear how the superannuation industry will be able to submit the appropriate information to the ATO for 2005-06 as the necessary systems have not yet been established.

Mercer believes that these transitional issues are important for individuals and that the Government should clarify transitional arrangements as soon as practical. A deferral of the starting date for the undeducted contribution limit to 1 July 2006 is one practical way forward.

The budget puts forward a very broad set of changes to the way every super fund is administered. Funds are struggling with implementing 2006 changes such as fee disclosure, new compliance reporting and contribution splitting. Changes of the magnitude of those announced need significant lead time (preferably at least 12 months) between the detail of the changes being known and the changes taking effect if the super industry is to implement them effectively. However, the changes are so fundamental that significant time will be required in consultation and developing legislation, so we are unlikely to see legislation until the end of 2006 or early 2007. This will make 1 July 2007 a difficult timeline for the superannuation industry to implement. Finally, many funds will be winding up before 30 June 2006 due to the effects of APRA licensing.

Impact on pensions

The simplification of benefit taxes and the pension rules means that the incentive for individuals to convert their retirement benefit into a regular retirement income stream, payable for several years, has been reduced. Whilst the tax-exempt status of the earnings on assets supporting pensions will encourage individuals to transfer their benefits from their superannuation fund to a pension fund, there is now no guarantee that these funds will provide income for many years.

Mercer welcomes the flexibility of the new arrangements for retirees but recognises that the proposed pension standards do not encourage the provision of pensions that tackle the longevity risk faced by many retirees. Mercer looks forwards to working with industry to develop new products that meet the Government standards and respond to the needs of retirees.

There are many retirees who are currently receiving income from existing pension arrangements based on current rules. It is unclear as to whether some or all of these income streams can be converted under the proposed rules.

Mercer believes that these transitional issues are important for many retirees and that the Government should clarify these arrangements as soon as is practical.

Untaxed superannuation schemes, which generally cover public servants, receive special treatment under the plan. There are a number of fundamental differences between the treatment of members of taxed schemes and members of untaxed schemes. These include no contribution limit; a maximum lump sum benefit of $700,000; and the treatment of any pension as reportable income together with a 10% rebate. However there is nothing preventing an individual from being a member of both a taxed scheme and an untaxed scheme and thereby receiving benefits from both arrangements.

Mercer recognises that untaxed schemes have special conditions. Nevertheless Mercer advocates that, as far as possible, the same rules should apply to members of taxed and untaxed schemes.

Next Steps

Many of the proposed changes will be welcomed by employers, their employees and industry. Mercer will provide submissions to Government during the consultation period, before these changes are legislated covering the following topics:

- Contribution limits
- Mechanism for excess contributions
- Defined benefit schemes
- Benefit taxes
- Pensions
- Public sector schemes
- Self employed
- Employer ETPs
- Other issues

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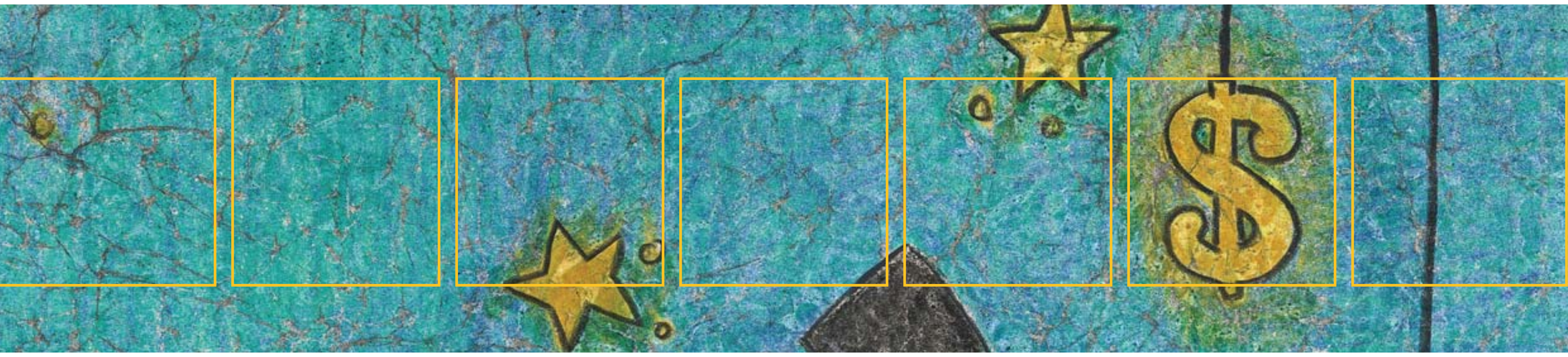

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