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1 August 2006

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

Subject:
**Mercer Submission No. 4 – Benefit Taxes**

Dear Sir

This is the fourth 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**

- Setting the pre-July 1983 component as a fixed amount;
- The tax treatment of death benefits; and
- The removal of Reasonable Benefit Limits.

We have also considered the long term tax treatment of lump sum and pension invalidity benefits and the short term tax treatment of excessive benefits.

## Executive Summary

We are generally in agreement with the Government's proposals regarding taxes on benefits however there are many practical issues to be considered which were not specifically covered in the Government's Plan.

In this report we have:
- Outlined some practical issues relating to the calculation of the pre-July 1983 component and made recommendations on how these should be handled;
- Recommended that the tax on death benefits should be removed to provide greater equity and simplicity, and considerably reduce administration costs;

- Recommended changes to the tax treatment of invalidity benefits (both lump sums and pensions) to provide greater equity and to remove current inconsistent treatments;
- Recommended changes to the Bankruptcy Act and the Superannuation Guarantee (Administration) Act which will be necessary following the removal of Reasonable Benefit Limits; and
- Recommended a reduction in the tax on excessive benefits received before 1 July 2007 to reflect the reduction in the top marginal tax rate.

The attached report sets out more background and reasoning behind the recommendations outlined above.

Our full recommendations are set out in Appendix 1 to this letter.

In Appendix 2, we have listed the previous submissions made by Mercer on the Government's discussion paper. We intend making several more submissions by 9 August 2006.

Please contact either John Ward (03 9623 5552) or David Knox (03 9623 5464) if you wish to discuss any of these issues. They will be happy to elaborate further on our ideas.

Yours Sincerely

Peter Promnitz
Chief Executive

MERCER
Human Resource Consulting



**APPENDIX 1: Mercer Recommendations In Relation To Benefit Taxes**

| | Recommendations | Government Discussion Paper Reference |
|---|---|---|
| **Calculation of pre-July 1983 component – Refer to Section 1 of attached report** | | |
| 1.1 | The pre-July 1983 component should be calculated based on:<br>• The full account balance for fully vested and partially vested accumulation arrangements;<br>• The greater of the vested benefit and the accrued retirement benefit for defined benefit arrangements;<br>• The pension account value for account based pensions where the pensioner has not reached age 60;<br>• The lump sum option for non-account based commutable pensions;<br>• The actuarial value of the pension for non-account based pensions where no commuted value exists. | 2.3.1 |
| 1.2 | It should not be necessary to calculate a pre-July 1983 component for existing pensioners who have reached age 60 provided the tax on death benefits is removed. | |
| 1.3 | The Government should undertake an advertising campaign to alert members to the new rules and the possible advantages of consolidating accounts. | |
| 1.4 | Funds should calculate and freeze the pre-July 1983 component as at 1 July 2008. This will give members time to consolidate accounts and for funds to implement the necessary system changes. | 2.3.1 |

| Death Benefits – Refer to Section 2 of attached report | | |
|---|---|---|
| 2.1 | All lump sum death benefits and reversionary pension benefits should be tax free. This change would minimise confusion, remove the complexity of trustees determining dependency, simplify record keeping, remove anomalies and avoid "death bed" manipulations. If this change is unacceptable to the Government, some of these problems could be reduced but not removed by adopting the "SIS" definition of dependant for tax purposes. | 2.4 |
| 2.2 | Reversionary pensions should only be allowed to be paid to a spouse or former spouse of the pensioner, rather than to dependants. Exemptions should apply in respect of existing members and existing pensioners (including after a successor fund transfer) where provisions already exist to enable reversionary pensions to be paid to other beneficiaries. | 2.4 |
| 2.3 | The anti-detriment provisions should be removed for all cases where death occurs on or after 1 July 2007. | |

| Lump Sum Invalidity Benefits – Refer to Section 3 of attached report | | |
|---|---|---|
| 3.1 | The invalidity component should be determined as the whole benefit entitlement payable on disability. This amount should be calculated when the trustee considers that the appropriate disability conditions have been satisfied, fixed as a dollar amount at that time and added to the exempt component. | |
| 3.2 | If the Government does not agree to implement recommendation 3.1 to remove tax on all benefits paid as a result of invalidity, Section 27G of the ITAA 1936 should be amended to enable the post-June 1994 invalidity component to be determined and fixed irrespective of whether the benefit is rolled over or retained in the current fund. | |

| Disability Income Benefits – Refer to Section 4 of attached report | | |
|---|---|---|
| 4.1 | All disability income benefits paid on a taxed basis, whether they are called salary continuance or disability income, should be taxed on a consistent basis: tax free from age 60, and taxed as income with a 15% tax offset prior to age 60. A deductible amount would only be allowed in limited circumstances. | |

| | | |
|---|---|---|
| 4.2 | All premiums, including notional premiums, for disability income benefits, whether they are called salary continuance or disability income, should be tax deductible to the fund. | |

| **Removal of Reasonable Benefit Limits – Refer to Section 5 of attached report** | | |
|---|---|---|
| 5.1 | The Bankruptcy Act should be amended so that benefits which accrued up to 27 July 2006 (or some other more convenient date such as 1 July 2007) continue to be protected up to an amount approximating the pension RBL, say $1.4 million (indexed to AWOTE). | 2.2.1 |
| 5.2 | New irrevocable elections to forgo rights to SG contributions should not be allowed from 1 July 2007. Existing elections could either remain in force or be deemed to expire on 30 June 2007. | 2.2.1 |

| **Tax on Excessive Component prior to 1 July 2007 – Refer to Section 6 of attached report** | | |
|---|---|---|
| 6.1 | For the year ending 30 June 2007, the tax rate applicable to the excessive component of an ETP that would have otherwise been treated as a post-June 83 component should be reduced from 38% to 35.5%. | |

**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 |
| Submission No.2 – Deductible Contributions | 13 July 2006 |
| Submission No.3 – Portability | 31 July 2006 |

1 August 2006

# A Plan to Simplify and Streamline Superannuation

# Submission No 4: Benefit Taxes

The Treasury

MERCER
Human Resource Consulting

MMC Marsh & McLennan Companies

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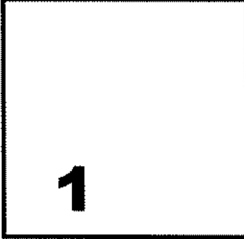



## Section 1: Calculation of pre-July 1983 component

The Government has proposed that the pre-July 1983 component will become a fixed amount at a particular date. The current small level of tax applicable on pre-July 1983 components will be removed.

*How should the amount be calculated – fully vested accumulation plans?*

For a fully vested accumulation plan, the calculation of the pre-July 1983 component is reasonably straightforward. The calculation would presumably be based on the member's account balance as at the date of the calculation.

We note that the Government's proposals will have an immediately favourable (albeit small) impact on members who cash their benefit in the short term. This is a result of the proposed removal of tax on this component. However in the longer term, the impact on members is likely to be negative as a smaller portion of the eventual benefit will be treated as pre-July 1983.

We do not see this as an impediment to the proposed changes as members will have the option of deferring their benefit until age 60 when no tax will apply. The increasing adverse impact will generally apply only gradually.

However this change could have a very significant impact on members who may become entitled to an invalidity benefit in the short term. An invalidity benefit may be significantly greater than the member's account balance and the frozen pre-July 1983 component may be considerably lower than the pre-July 1983 component that would have applied on the current basis. Increasing the tax on members who become disabled is not desirable. There would appear to be no easy way of modifying the Government's pre-July 1983 proposal to avoid this problem. However, the removal of tax on lump sum invalidity benefits as recommended in Section 3 would remove this problem.

*How should the amount be calculated – partially vested accumulation plans?*

A significant difficulty with partially vested accumulation plans is that it is not known what the benefit will actually be. Should the calculation of the pre-July 1983 component be based on the full account balance as at the calculation date or on the vested benefit as at that date?

In our view it would be more equitable if the benefit was based on the full account balance rather than the vested portion.

*How should the amount be calculated – defined benefit plans?*

Similarly to a partially vested accumulation plan, it is unclear how the pre-July 1983 component should be calculated as the benefits provided are likely to vary depending on the reason a benefit becomes payable.

With some defined benefit plans there might be significant increases in benefit on reaching a particular age, eg 55. It would therefore be unreasonable to determine the frozen pre-July 1983 component based on the resignation benefit when a much higher benefit may have become payable a few days or weeks later. Both the expected retirement benefit and the current vested benefit should be taken into account for this purpose. For example, the frozen pre-July 1983 component could be based on the greater of the vested benefit and the accrued retirement benefit.

*How should the amount be calculated – existing pensions where pensioner is over age 60?*

Because pensions and any subsequent lump sums (except for some death benefits) will be tax free, the only reason that a pre-July 1983 component needs to be determined for these pensions would be for the purposes of calculating a death benefit that might eventually be payable to a non-dependant.

We have recommended (refer to Section 2) that the tax on death benefits be removed. This would remove entirely the need to calculate a pre-July 1983 component for existing pensioners over age 60.

*How should the amount be calculated – existing pensions where pensioner has not reached age 60?*

For account based pensions, the pre-July 1983 component could be calculated based on the account balance at the relevant date. However, the proposed changes to the calculation of the deductible amount concern us.

For commutable pensions that are not account based, including life time pensions, the value of the lump sum option applicable at the relevant date could be used.

For non-commutable pensions that are not account based, including life time and life expectancy pensions, there may be no relevant value to use (unless there is a value that

could be applied if the pensioner was able to rollover to another similar pension). In these cases it would be necessary to specify how the value is to be calculated. This could be the value placed on the pension using the assumptions adopted at the most recent actuarial valuation.

For all of these pensions, we want to avoid a situation where members are effectively forced to commute an existing pension in order to take advantage of a higher deductible amount. We will discuss this in more detail in a subsequent submission.

**Recommendation 1.1: The pre-July 1983 component should be calculated based on:**

- **The full account balance for fully vested and partially vested accumulation arrangements;**
- **The greater of the vested benefit and the accrued retirement benefit for defined benefit arrangements;**
- **The pension account value for account based pensions where the pensioner has not reached age 60;**
- **The lump sum option for non-account based commutable pensions;**
- **The actuarial value of the pension for non-account based pensions where no commuted value exists.**

**Recommendation 1.2: It should not be necessary to calculate a pre-July 1983 component for existing pensioners who have reached age 60 provided the tax on death benefits is removed.**

*Member notification*

Currently many members who have more than one superannuation fund will combine their superannuation prior to retirement so that their earliest eligible service date can apply to their total benefit.

Members need to be advised that this consolidation will now need to occur before their fund determines the frozen pre-July 1983 component. Funds may need to advise members of this requirement and members will need time to arrange rollovers/ transfers.

We expect that many funds will make members aware of these changes and the possible advantages of consolidating accounts. However, where the trustee does not have an Australian Financial Services Licence, they will be unable to provide advice to members. In any event, we expect that members may take more notice of Government advertising which would be seen as more independent.

**Recommendation 1.3: The Government should undertake an advertising campaign to alert members to the new rules and the possible advantages of consolidating accounts.**

*What should the particular date be?*

It will generally be easier for a fund to perform the necessary calculations as at the fund's normal annual review date. This date could be any date throughout the year.

There is therefore an argument that the legislation should allow some flexibility for funds to choose the most appropriate date from their perspective.

However, such an option is likely to create significant confusion as four possible scenarios exist where a benefit is rolled over or transferred from Fund A to Fund B:

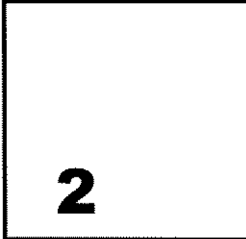
- Fund A has frozen the pre-July 1983 component but Fund B has not;
- Fund A has not frozen the pre-July 1983 component but Fund B has;
- Both Fund A and Fund B have frozen the pre-July 1983 component;
- Neither Fund A nor Fund B has frozen the pre-July 1983 component.

In our view the freezing should take place on the same date in all funds.

As indicated above, some time is needed for members to be advised and arrange any necessary rollovers/ transfers.

Funds will also need time to implement appropriate system changes.

**Recommendation 1.4: Funds should calculate and freeze the pre-July 1983 component as at 1 July 2008. This will give members time to consolidate accounts and for funds to implement the necessary system changes.**



# Section 2: Death Benefits

The payment of death benefits can become very complex for trustees. A significant part of the complexity relates to the tax treatment of death benefits. Whilst the proposed changes will result in some simplification, we believe that further simplification is required.

There are also other (non-tax related) complexities relating to the payment of death benefits however we will discuss these in another submission.

*Proposed treatment of death benefits*

Our understanding of the Government's proposals for taxed schemes is as follows:

| Type of death benefit | Proposed treatment |
|---|---|
| Lump sum paid to a dependant | tax free |
| Lump sum paid to a non-dependant | 15% of the taxable component |
| Reversionary pension paid to a dependant | • if original pensioner was aged 60 or over – tax free<br>• if original pensioner was under age 60 at date of death - taxed (except for deductible part) as normal income with 15% rebate until beneficiary reaches age 60 and then tax free |
| Reversionary pension paid to a non-dependant | Not allowed |

Whilst the above system is simpler than at present, we have a number of concerns, as follows:

- Superannuation fund trustees will have to continue operating as tax assessors as they will need to decide whether certain dependants are financially dependent for the purposes of determining whether tax is to be deducted or not;
- Even though pensions will be tax free from age 60, superannuation funds will need to continue updating the Unused Undeducted Purchase Price (UUPP) for pensions for more than 25 years, just in case the pensioner dies and a lump sum death benefit is paid to a person (other than a spouse, minor child or person in an interdependency relationship) who is not financially dependent on the deceased;
- There is a potentially significant difference in the tax treatment of pension benefits if a pensioner dies just prior to age 60 compared to death occurring just after age 60;
- There is a potentially significant difference in the tax treatment if a member aged over 60 cashes their superannuation lump sum or pension just before death compared to a lump sum death benefit payable from a superannuation fund; and
- The combination of the proposed death benefit tax rules and the proposals to fix the pre-July 1983 component and change the method of determining the deductible amount will result in considerable extra work for existing pensioners. Potentially, existing pensioners would need to consider whether they should commute their existing pension and replace it with a new one for the purposes of reducing the potential tax payable on their death.

*Trustee acting as tax assessor*

On the death of a member, trustees need to determine the appropriate beneficiaries. In particular, the trustee would need to first determine whether or not the potential beneficiary meets the definition of dependant as required by the SIS legislation and meets the requirements as set out in the fund's trust deed. It is only in rare situations where a death benefit can be paid to a non-dependant.

Having determined who should receive the death benefit, the trustee then needs to consider the tax implications. For this purpose, the trustee must consider the relevant definition of dependant in the Income Tax Assessment Act. This "Tax" definition is different to the "SIS" definition. (The "Tax" definition excludes adult children unless they are either financially dependent on, or in an interdependency relationship with the deceased whereas the "SIS" definition includes such children.)

If a financial dependency or interdependency relationship cannot be established, then the trustee must deduct tax from the benefit.

We note that such decisions are often extremely difficult to make as dependency is generally not clear cut.

In some cases the trustee may determine to split a death benefit evenly between, say two children, one who is an adult (not financially dependent) and the other a minor child. The

benefit paid to the minor child is tax free whereas the benefit paid to the adult child is subject to tax. Yet tax could be avoided if the trustee pays the whole benefit to the minor child who's guardian then passes half of it on to the other child. Acting in the interests of the parties, the trustee may feel obliged to take this route although it is clearly placed in a difficult position.

In our view, it is inappropriate for the trustee to determine whether or not tax should be withheld on the basis of dependency. The trustee's role should be to manage the superannuation fund in the interests of its members – not to act as a tax assessor.

Most death benefits are paid to the spouse or to adult or minor children of the deceased. If the "Tax" definition of dependant was changed to the same as the "SIS" definition, this would not only simplify the legislation by removing an inconsistency, but would also simplify the work of the trustee.

There would however, still be a requirement to determine dependency etc for any other beneficiaries who are not the deceased's spouse or child.

*Record keeping complexities*

The Government has proposed that pensions from a "taxed" scheme will not be subject to tax from age 60. This is considerably simpler than the current system where the part of the pension is tax free (the deductible amount) and the balance subject to tax although there is a 15% tax offset.

If the pension is tax free, then the deductible amount will no longer be required for the purpose of determining the tax payable by the pensioner.

Likewise, if the pension is commuted by the pensioner, the resulting lump sum is not subject to tax and so there is no need to determine the UUPP.

However, if a pensioner dies and the resultant death benefit is payable to a non-dependant, then it will be necessary to determine the initial Undeducted Purchase Price, the deductible amount and the UUPP. This may be required 25 years or more from when the pension commenced. It is possible that these records will have been lost over that period, particularly in the SMSF area where full records may not always be maintained.

In any event, if the system is to be simplified, it appears odd that such records will need to be kept for such long periods for only one purpose – the determination of tax on eventual death benefits (if any) payable to non-dependants.

If the "Tax" definition of dependant is replaced by the "SIS" definition, this would reduce the number of cases where the UUPP would be required. However it would still be necessary to maintain and update the records for all pensioners, just in case a death benefit is paid to a non-dependant.

*Inequities on death of pensioner before/after age 60*

If a pensioner dies shortly after his/her 60th birthday, any resultant reversionary pension payable to a dependant will be tax free. However if death occurs just prior to age 60, the resultant pension may be subject to tax, albeit with an associated 15% tax offset, for many years until the reversionary pensioner reaches age 60.

This will create anomalies. In some cases it could result in family members trying to maintain the pensioner's life until age 60 by extreme life support measures, and hence incurring significant health costs to the community.

*Inequities on death of superannuation member after/before cashing superannuation*

A member over age 60 can cash their superannuation at any time. No tax would be payable. However if the member dies before cashing, tax of up to 15% could be payable (if the benefit is payable to a non-dependant).

This could also result in anomalies and leads to the possibility of "death bed cashing". We can envisage family members trying to get a dying person to sign a superannuation withdrawal request to minimise the tax. This is likely to result in additional trauma for the dying and their relatives.

Such situations can also result in problems for superannuation funds, particularly if the payment of the member's account balance is not paid until after the date of death (and should technically be treated as a death benefit for the purposes of claim staking and tax).

Again, the use of the "SIS" definition for tax purposes would reduce the problem significantly, but not eliminate it.

*Impact on existing pensioners*

As indicated in Section 1, the proposal to fix the pre-July 1983 component in dollar terms and to enable this to be treated as part of the Undeducted Purchase Price when purchasing a pension also has an impact in relation to existing pensioners.

For existing pensioners over age 60, the only reason that the pre-July 1983 component would need to be calculated would be for the purposes of calculating the tax on a death benefit that might, at some future date, be payable to a non-dependant.

Depending on how the changes are made, it might also be advantageous for some pensioners to commute their existing pension and commence a new one, just for the purpose of reducing the tax that might become payable in some circumstances in future. We will cover this issue in more detail in a later submission but the problems arising from it would be avoided if the tax on all death benefits was removed.

**Recommendation 2.1: All lump sum death benefits and reversionary pension benefits should be tax free. This change would minimise confusion, remove the complexity of trustees determining dependency, simplify record keeping, remove**

**anomalies and avoid "death bed" manipulations. If this change is unacceptable to the Government, some of these problems could be reduced but not removed by adopting the "SIS" definition of dependant for tax purposes.**

*Pension benefits*

The present system enables reversionary pension benefits to be paid to any dependant according to the "SIS" definition. It is unclear whether the Government is proposing to restrict the payment of reversionary pensions to dependants who meet the "SIS" definition or the more restrictive "Tax" definition.

In any event, if reversionary pensions are to be treated as tax free, we can understand that the Government may be concerned that tax free pensions could be payable for many years and that superannuation could then be used as a means of estate planning.

We would share that concern. However rather than complicating the tax system to minimise the effect, we believe that appropriate adjustments to the pension rules would effectively eliminate this as a problem. We propose that the restrictions on reversionary pensioners be **extended**. In particular, we consider that reversionary pensions should only be allowed to be paid to the pensioner's spouse or former spouse.

However, some funds currently allow reversionary pensions to be paid to other beneficiaries. Where there is an existing right to pay such pensions if death occurs, then this should be allowed to continue. This right should also continue following a successor fund transfer. Our proposed new rule should only apply in respect of new members, or in cases where there is currently no provisions for paying reversionary pensions to those other that a spouse or former spouse.

**Recommendation 2.2: Reversionary pensions should only be allowed to be paid to a spouse or former spouse of the pensioner, rather than to dependants. Exemptions should apply in respect of existing members and existing pensioners (including after a successor fund transfer) where provisions already exist to enable reversionary pensions to be paid to other beneficiaries.**

*Anti-detriment payments*

A significant complication for trustees is the provision of anti-detriment payments on death (in accordance with Section 279D of the Income tax Assessment Act 1936).

We recall that these provisions were a last minute inclusion in the 1988 changes that introduced contribution tax. The anti-detriment provisions minimised the impact of the contribution tax on death benefits which had always been tax free but would generally have been reduced following the introduction of contribution tax.

However, these anti-detriment payments are complex to calculate and difficult to explain to members (prior to death) and potential beneficiaries. In broad terms the anti-detriment payment will offset the contribution tax that has already been paid. The superannuation

scheme can claim a tax deduction equal to the anti-detriment payment made divided by 0.15. This tax deduction covers the cost of the anti-detriment payment.

Whilst there may have been some logic in providing transitional protection for death benefits paid shortly after the 1988 changes, the actual provisions apply indefinitely. There no longer appears to be any real logic for these provisions.

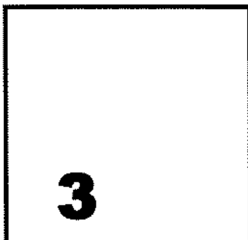
We also note that the provisions are inequitable because not all funds can use them. For example, unless an accumulation fund has reserves, it may not be able to finance the payment for the period between when the payment of the anti-detriment benefit is made and when the benefit of the tax deduction is received.

Even where a scheme is prepared to make the additional payment, if the benefit is paid to the member's legal personal representative, the trustee may not know the eventual beneficiaries and will therefore be unable to determine whether it will be able to claim a tax deduction.

The cost involved in calculating the anti-detriment amount must also be recouped. Often this may involve the costs of auditors or actuaries calculating and certifying the amount involved. Yet it is not generally possible to recoup these costs from the beneficiary – they must generally be met by the other members of the fund.

If we are to achieve a simpler system, then some of the existing complexities must be discarded. This includes those complexities which can operate to the advantage of some members. In view of the favourable changes to tax on benefits after age 60, we consider that now is the ideal time to remove these anti-detriment provisions.

**Recommendation 2.3: The Section 279D anti-detriment provisions should be removed for all cases where death occurs on or after 1 July 2007.**



# Section 3: Lump Sum Invalidity Benefits

No change has been proposed to the taxation of invalidity benefits although such benefits will also be tax free if paid after age 60.

We consider that invalidity benefits are effectively a form of compulsory retirement benefits. If genuine retirement benefits are to be treated as tax free after age 60, then consideration should also be given to making genuine invalidity benefits at all ages tax free as well.

Even under the current rules, if a young person becomes disabled and qualifies for an invalidity payment, the majority of the benefit will be tax free because of the post-June 1994 invalidity component.

For those who become disabled at older ages, it will also be possible to avoid tax by only drawing down the post-June 1994 invalidity component and amounts up to the tax free threshold before age 60.

We therefore consider that extending the tax free status to all invalidity payments from a superannuation fund is unlikely to involve significant cost to the Government, whilst further assisting with simplification of the superannuation system.

To avoid extending the tax free status to all future benefits such as investment earnings and future contributions (eg contributions made if the person could perform some work at a lower level, or contributions paid by a spouse and transferred to the disabled person's account using contribution splitting) we propose that the post-June 1994 invalidity component be calculated as the full benefit entitlement that would have been paid on account of disablement. This amount would then be fixed and form part of the tax exempt component.

**Recommendation 3.1: The invalidity component should be determined as the whole benefit entitlement payable on invalidity. This amount should be calculated when**

**the trustee considers that the appropriate invalidity conditions have been satisfied, fixed as a dollar amount at that time and added to the exempt component.**

*Current problems with invalidity components*

In any event, the current tax treatment of post-June 1994 invalidity components needs to be addressed.

We are particularly concerned with the complexity of this component. Based on the requirements of Section 27G of the Income Tax Assessment Act 1936 and also TR 2003/13, the post-June 1994 invalidity component is not determined until a benefit is actually paid or rolled out of the fund.

This means that a member could rollover a benefit to another fund and immediately establish a post-June 1994 invalidity component in that fund. This component is calculated as a proportion of the amount rolled over. This amount is then fixed but can effectively be withdrawn at any time without impacting on other components of the benefit. (The proportion is normally calculated as the number of days from date of terminating employment due to invalidity to the 65th birthday divided by the number of days from the person's eligible service date to the 65th birthday.)

However, a member who decides to retain their benefit in their original fund cannot establish a post-June 1994 invalidity component until a benefit is actually paid (or subsequently rolled over). In this case, the same proportion of the amount paid or rolled-over is used but it is only applied to the part of the benefit that is being rolled over or paid out at the time.

This results in much confusion and significant anomalies.

Consider the following example:

> A member is disabled at age 49 after 24 years eligible service and is entitled to a benefit of $300,000. The invalidity component will be determined as 16 years/40 years (= 40%) of any amount payable.
>
> If the member rolls over the benefit, the post-June 1994 invalidity component will be $120,000 (= 40% x $300,000). This amount is then fixed. Assuming the benefit grows to $450,000 over the next 5 years (age 54), the post-June 1994 invalidity component remains at $120,000.
>
> On the other hand, if the member decides to retain the benefit in their original fund, the post-June 1994 invalidity component is not determined until the eventual benefit becomes payable. Assuming the benefit in the original fund has also risen to $450,000, and the whole benefit is paid out or rolled over at that time, the post-June 1994 invalidity component will be 40% of the increased amount, ie $180,000.

In other words, the member who leaves the benefit in the original fund can obtain a significantly higher invalidity component.

However, now assume that the member only wants to withdraw $100,000 at age 54, perhaps to finance renovations to the home to permit disabled access.

If the whole benefit had been rolled over initially, the whole $100,000 required could be treated as a post-June 1994 invalidity component. No tax would be payable.

On the other hand, the member who had not rolled over has not yet quantified a post-June 1994 invalidity component. Of the $100,000 withdrawn, only 40% (the original invalidity percentage) could be treated as a post-June 1994 invalidity component. The balance will be treated as a post-June 83 component and taxed at 21.5% (assuming that the member has not reached age 55).

In some cases, members must be advised to rollover their whole benefit before cashing part of it. Such a system is not simple and members can very easily make decisions that will cost them thousands of dollars.

The current system also creates significant difficulties for funds where benefits have been retained in the original fund. The tax calculation is extremely unclear if a member rolls in further superannuation benefits or the fund receives additional contributions after the invalidity has occurred.

**Recommendation 3.2: If the Government does not agree to implement recommendation 3.1 to remove tax on all benefits paid as a result of invalidity, Section 27G of the ITAA 1936 should be amended to enable the post-June 1994 invalidity component to be determined and fixed irrespective of whether the benefit is rolled over or retained in the current fund.**

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## Section 4: Disability Income Benefits

This is another aspect of the current system that is extremely confusing.

There are generally 2 types of income benefit payable in respect of invalidity:

- Salary continuance benefits; and
- Disability pensions.

The differences between these two types of benefit can be minimal and it is often difficult to distinguish between them. However the treatment of them is quite different. We expand on these differences below:

| Issue | Salary Continuance | Disability Income |
|---|---|---|
| How is benefit calculated? | Normally expressed as a standard percentage of salary but could be calculated using other methods. | Could be expressed as a standard percentage of salary or could be calculated based on period of membership completed and prospective membership to age 65. |
| How long is benefit payable for? | Periods vary from fund to fund. May be 2 years but can also be payable for the remaining period to age 65. | Normally payable for either the period to age 65 or for the remainder of life. |
| Can benefit cease earlier? | Yes, if member recovers. It may also cease if the member elects to take a lump sum total and permanent disablement benefit or resigns from his/her employer. | In some cases it can cease if the member recovers. |

| What happens to accruing retirement benefit? | Generally continues to grow with additional contributions (or additional accruals in a defined benefit fund). | Varied. |
|---|---|---|
| Current treatment of premiums (or notional premiums) | Only the premium in respect of the first 2 years of benefit is tax deductible to the fund. | Tax deductible to fund. |
| Tax payable on income benefit (current system) | Taxed at marginal rates with **no** 15% tax offset or deductible amount. | Taxed at marginal rates with a 15% tax offset applicable and potentially a deductible amount. |
| Current treatment for RBL purposes | Not counted against RBL. Not reported for RBL purposes. | Counted and reported for RBL purposes. |

The actual picture is more clouded than this as there are potentially many shades of grey with funds offering benefit designs that lie between the types of income benefit described above.

*Tax on benefits*

In our view, the similarities of the benefits are such that they should be treated the same. The removal of the RBL system will simplify the process of treating them the same.

If changes are not made, there is a danger that salary continuance benefits paid after age 60 would be subject to tax even though other benefits received after age 60 are tax free.

There is some logic in arguing that all salary continuance and disability income benefits paid from a superannuation fund should be tax free. This would be consistent with our recommendation for lump sum invalidity benefits. However, this could cause some inconsistencies with the tax treatment of salary continuance benefits payable outside of the superannuation system.

Whilst consistency with non-superannuation products is desirable, there also needs to be consistency within the superannuation system.

We therefore propose that all disability income and salary continuance benefits paid from a "taxed" superannuation fund be treated as follows:

- Tax free from age 60
- Taxed in the same manner as other pensions prior to age 60, including the provision of a 15% tax offset.

Consideration would also need to be given to a deductible amount. In our view, it would be inappropriate to apply a deductible amount where the accrued retirement benefit is not affected by the income benefit which is normally fully funded by insurance (ie the income benefit is payable in addition to any retirement benefit). A deductible amount would apply only where the income benefit is payable for life or is drawing down on the accrued benefit.

**Recommendation 4.1: All disability income benefits paid on a taxed basis, whether they are called salary continuance or disability income, should be taxed on a consistent basis: tax free from age 60, and taxed as income with a 15% tax offset prior to age 60. A deductible amount would only be allowed in limited circumstances.**

*Tax deductibility*

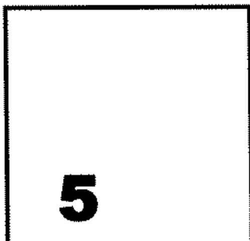
The fact that some part of the salary continuance premium is not tax deductible to the fund is inequitable. It is also very difficult for funds to administer.

If paid by the individual (outside the superannuation system) the premium would be tax deductible.

If paid by the individual's employer, the premium would be tax deductible (and not subject to FBT).

There appears to be no logic as to why only part of the premium is tax deductible when paid by the trustee of the individual's superannuation fund.

**Recommendation 4.2: All premiums, including notional premiums, for disability income benefits, whether they are called salary continuance or disability income, should be tax deductible to the fund.**




## Section 5: Removal of Reasonable Benefit Limits

As indicated in other submissions, we are in favour of the removal of the Reasonable Benefit Limits.

However this has some associated implications which are not immediately obvious.

*Bankruptcy protection*

Currently superannuation assets up to the pension RBL are protected from creditors in the event of bankruptcy (Section 116 of the Bankruptcy Act).

With the removal of the RBL system, this protection may no longer be available. We assume that this may be an unintended consequence of the proposed changes.

We also understand that the Government has recently announced plans to amend legislation to enable bankruptcy trustees to recover superannuation contributions made prior to bankruptcy with the intention to defeat creditors. It will apply to contributions made after 27 July 2006.

We are however concerned that with the removal of the RBL system, benefits which accrued prior to 27 July 2006 may no longer be protected.

We continue to believe that some protection on bankruptcy in relation to benefits accrued up to 27 July 2006 is required and that the Bankruptcy Act should be amended to incorporate a similar level of protection to that currently afforded. Basing the protection on the benefits applicable as at a more convenient date (for example 1 July 2006 or 1 July 2007) will produce a broadly similar result but may be easier to administer.

**Recommendation 5.1: The Bankruptcy Act should be amended so that benefits which accrued up to 27 July 2006 (or some other more convenient date such as**

**1 July 2007) continue to be protected up to an amount approximating the pension RBL, say $1.4 million (indexed to AWOTE).**

*Superannuation Guarantee Requirements*

Section 19(4) of the Superannuation Guarantee (Administration) Act enables an employee to make an irrevocable election to forgo future SG contributions if his/her benefits have already exceeded the pension RBL.

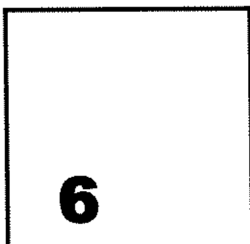
This provided some ability for members to minimise the amount of benefits that would be in excess of the old RBLs.

With the removal of the RBL system, there is no longer any reason for this provision.

Any existing irrevocable elections should be retained. No new ones should be possible from 1 July 2007. Individuals who have an existing irrevocable election in place but change employers would not be able to put a new irrevocable election in place with a new employer.

Alternatively, all existing elections could be deemed to expire on 30 June 2007 and hence totally remove this exemption.

**Recommendation 5.2: New irrevocable elections to forgo rights to SG contributions should not be allowed from 1 July 2007. Existing elections could either remain in force or be deemed to expire on 30 June 2007.**



# Section 6: Tax on Excessive Component prior to 1 July 2007

In 2000, the Tax Act was amended to reduce the tax on the excessive component of an ETP that would otherwise have been treated as a post-June 83 taxed component to 38% (plus Medicare). This was to ensure that an excessive benefit was taxed at no more than the top marginal tax rate after taking into account the 15% contributions tax already incurred on the contributions. The tax rate on the remainder of the excessive component (if any) is 47% (plus Medicare). These rates are set out in Parts I and II of Schedule 7 of the Income Tax Rates Act 1986.

With the reduction in the top marginal tax rate from 47% to 45% from 1 July 2006, there should be a similar reduction in the rate of tax on the excessive component of an ETP that would otherwise have been treated as a post-June 83 taxed component. Admittedly, this will only be relevant for the period up to 30 June 2007 as the Government has proposed the removal of excessive components from 1 July 2007.

However, the Tax Laws Amendment (Personal Tax Reduction and Improved Depreciation Arrangements) Bill, which amends the Income Tax Rates Act, does not reduce this rate (although it does reduce the rate of tax on the remaining excessive component to 45%). We recommend that paragraph 1(a) of Parts I and II of Schedule 7 of the Income Tax Rates Act 1986 be amended to reduce the rate of tax on the excessive component of an ETP that would otherwise have been treated as a post-June 83 taxed component to 35.5%.

The 35.5% rate has been calculated in a similar manner to the calculation of the current 38% rate but takes into account the reduction in the top marginal tax rate.

(Income of $100 that is subject to the top marginal tax rate of 45% results in an after tax amount of $55. The tax rate applicable to the excessive component should result in a similar after tax amount after allowing for contribution tax.

A contribution of $100 will be subject to contribution tax of 15% leaving $85. A tax of 35.5% on this leaves an after tax benefit of $54.83 (approximately $55).)

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**Recommendation 6.1: For the year ending 30 June 2007, the tax rate applicable to the excessive component of an ETP that would have otherwise been treated as a post-June 83 component should be reduced from 38% to 35.5%.**

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