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9 August 2006

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

Subject:
Mercer Submission No. 6 – Defined Benefit Funds

Dear Sir

This is the 6th 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

- Defined benefit funds will need to determine a notional deductible contribution for each member for the purpose of comparing with the proposed limit on concessionally taxed deductible contributions.

Executive Summary

We believe that it is crucial that the extraordinary difficulties faced by superannuation funds and the ATO in dealing with the superannuation surcharge be avoided under the proposed system for members of defined benefit superannuation funds.

In particular we recommend that:

- any calculations involved in determining an additional tax liability should be clearly set out in the legislation;
- the calculation method adopted should be simple to apply and to incorporate in administration systems; and
- a review mechanism should be available where a more accurate determination can be made where a member has exceeded the limit based on the standard simple formula.

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We also note that the system would be considerably simplified if the deductible contribution limit is raised from the $50,000 pa limit proposed to $100,000 pa as recommended in Submission 2.

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 will also be providing two other submissions later today.

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

APPENDIX 1: Mercer Recommendations In Relation To Defined Benefit Funds

	Recommendations	Government Discussion Paper Reference
General – Refer to Section 1 of attached report		
1.1	The methodology for determining notional contributions should be clearly set out in either the Income Tax Assessment Act or associated Regulations in order to minimise disputes about the calculation method.	4.2
1.2	The method for determining notional contributions for defined benefit funds must be considerably simpler than the methodology previously required for surcharge purposes.	4.2
1.3	The methodology should be such that defined benefit members can estimate the likely level of employer-financed notional contributions for them for the year. The methodology should enable this estimate to be made *at the start of the year.*	4.2
1.4	A review mechanism should be available so that members who are unfairly affected by the methodology can request a review to take into account their specific circumstances.	4.2
Methodology – Refer to Section 2 of attached report		
2.1	A straightforward approach similar to that used in the UK and Canada should be adopted. (The actual mechanisms are discussed in the attached report.)	4.2
2.2	Notional contributions should be determined using a standard simple formula based on the retirement benefit accrual rate as outlined in the attached report with a more accurate review mechanism available in cases where the contribution limit is exceeded according to the standard formula (Method 1 in the report).	4.2

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
Submission No.4 – Benefit Taxes	1 August 2006
Submission No.5 – Untaxed Schemes	7 August 2006

9 August 2006

A Plan to Simplify and Streamline Superannuation

Submission No 6: Defined Benefit Funds

The Treasury

MERCER
Human Resource Consulting

MMC Marsh & McLennan Companies

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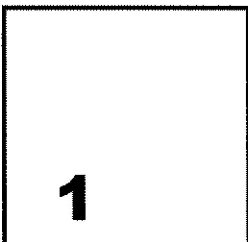


Section 1: Introduction

The Government has proposed a limit of $50,000 pa in relation to concessionally taxed deductible contributions.

The Government has also proposed that a notional contribution be determined and used by defined benefit funds for this purpose, as contributions are not allocated on a member by member basis in such funds.

This is very reminiscent of the superannuation surcharge legislation which created significant administrative and legal difficulties for superannuation funds and the ATO.

In Submission No. 2, we outlined some of the problems with the superannuation surcharge. Our recommendations in that Submission included:

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

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

Submission No. 2 then concentrated on the administrative mechanisms of reporting deductible contributions and the interaction between the member, the fund and the ATO.

It appeared clear to us that, for the proposed system to work efficiently for all concerned, funds should only be involved in reporting contributions. Any subsequent liaison should be between the ATO and the member rather than the ATO and the fund. Once any additional tax has been determined, the ATO should issue an assessment to the member. The member could request his/her superannuation fund to pay the tax on his/her behalf. Our recommended approach would significantly reduce the administrative problems that arose from the surcharge legislation.

It would also be more acceptable to members, as we have received complaints from members that they would prefer to pay the surcharge directly rather than having it grow with interest and be deducted from their superannuation benefits.

Furthermore, in contrast to surcharge, it is likely that only a relatively small number of high earners will be affected by the proposed limits. It is also likely that those affected will be financially sophisticated.

In this submission we concentrate on the special issues of defined benefit funds and, in particular, the need to determine notional contributions.

We also note that the number of members likely to be affected by the limit will reduce considerably if the proposed limit is increased. A limit of $100,000 pa (indexed) would mean that there would be few defined benefit members who would be affected (excluding those who are making significant additional contributions to accumulation arrangements). With a higher limit, we expect that most of the defined benefit members who are directly affected would have salaries of over $400,000. This would significantly reduce the administrative costs compared to a limit of $50,000 pa where a much greater (although still relatively small) number of defined benefit members would be likely to exceed the limit.

Notional contributions for surcharge purposes

We summarise below the problems that arose when assessing notional contributions for surcharge purposes. These should provide a useful list to consider when establishing a mechanism to calculate notional contributions for defined benefit members for the purpose of assessing whether the total deductible contributions fall above or below the annual limits. Problems included:

- Unclear legislation which resulted in many lawyers and actuaries adopting an interpretation which was inconsistent with the Government's intention;
- Initially, no legislative back-up for the methodology to be used. Whilst SCR 97/1 provided the Government's preferred methodology, it was not mandated, enabling actuaries to adopt other methods, even though the ATO subsequently refused to accept most such methods. It was not until the calculation requirements were included in Regulations and the Act amended, that some of these problems were resolved;
- The required methodology often resulted in very complex tables of notional contribution factors based on age, sex and duration of membership. The notional contribution factors were complex and expensive to prepare and costly for funds to implement in administration systems;
- From a cost effectiveness point of view, the costs involved for many schemes were disproportionately high relative to the amount of surcharge eventually collected;
- Despite the complex tables, the notional contributions still produced inequitable results in many cases and often bore no relationship to the actual benefit received. This particularly arose when a member left service before retirement date and was

only entitled to a resignation benefit, whereas the notional contributions included allowance for the member to receive a retirement benefit;
- Where an employer improved the level of benefits provided on some form of retrospective basis, an additional notional contribution resulted even though the member may never have benefited from the improvement; and
- The surcharge impacted many people in middle as well as high income brackets who were unable to avoid the surcharge once their adjusted taxable income exceeded the surcharge threshold.

Lessons to be learnt from surcharge

In hindsight, the introduction of surcharge would have been much more straightforward if the methodology of determining notional contributions had been included in either the surcharge legislation or the associated regulations. This would have removed some of the legal confusion.

The methodology used to determine notional contributions was also too complex, resulting in a disproportionate implementation and administrative costs and making it difficult for funds to administer and communicate to members.

Provisions should be included to protect members from being penalised in cases where the normal calculation method produces unreasonable results in their particular circumstances.

What is different this time?

There are several key differences.

Number of defined benefit funds and defined benefit members

- There are far less APRA regulated defined benefit funds than in 1996 when the surcharge was introduced;
- Most remaining defined benefit funds have been closed to new defined benefit members for some time;
- Amendments to the regulations in 2004 prohibit the establishment of new defined benefit funds with less than 50 members and prohibit the admission of new defined benefit members if there would be less than 50 defined benefit members;
- There are virtually no new defined benefit funds being established;
- The number of defined benefit members has fallen considerably.

Further, it is no longer possible for small employers to establish a new defined benefit fund or admit new members. This will significantly reduce the opportunity for funds to be set up in a manner specifically designed to minimise the notional contributions.

These changes mean that the number of members accruing defined benefits is much smaller than it was a decade ago, and is expected to continue to reduce. Hence the Government may well decide that simplicity has merit, given the limited revenue

impact. This should enable a more broad brush approach to be taken in order to minimise compliance costs.

Avoiding an additional tax liability

- With the surcharge, once adjusted taxable income exceeded the threshold, it was not possible to avoid the additional tax. Under the new proposals, most employees (assuming that they can estimate the likely notional deductible contributions) will be able to ensure that the limit on concessionally taxed contributions is not exceeded and hence avoid any additional tax. The number of employees who are subject to additional tax will therefore be significantly less than the number of employees who were required to pay a superannuation surcharge.

The proposed contribution limit will exceed the notional contributions determined for a very significant majority of defined benefit members. There will be some exceptions, in particular, highly paid employees in generous defined benefit schemes. Apart from these individuals, members will only exceed the limit if they make additional salary sacrifice contributions to the defined benefit fund or another fund. This means that it is important for members to be able to determine the notional contribution in advance so that additional contributions can be adjusted accordingly.

Impact of exceeding the limit

- With surcharge, if the adjusted taxable income limit was exceeded, the surcharge applied to **all** deductible contributions. Under the current proposals, the additional tax only applies to contributions in **excess** of the limit, although the rate of additional tax is considerably higher than the maximum rate of surcharge.

Conclusions

Based on the experience with surcharge, it would appear important that the methodology used to determine notional contributions be straightforward, clearly expressed and have appropriate legislative backing.

Recommendation 1.1: The methodology for determining notional contributions should be clearly set out in either the Income Tax Assessment Act or associated Regulations in order to minimise disputes about the calculation method.

With the considerable reduction in the number of defined benefit members since 1996 and the ability of most remaining members to limit their deductible contributions below the limit, only a small proportion of defined benefit members are likely to exceed the proposed limit. It is therefore important that any methodology be simple and cost effective to apply.

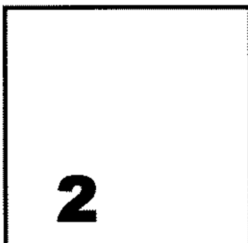
Recommendation 1.2: The method for determining notional contributions for defined benefit funds must be considerably simpler than the methodology previously required for surcharge purposes.

For those defined benefit members who would have been likely to exceed the proposed limit, we expect that most will want to adjust the level of contributions so as to avoid the additional tax. To do this, they will need to know, close to the start of the year, what their notional contributions are going to be. In this way, they will be able to adjust their other contributions (eg salary sacrifice) where necessary.

Recommendation 1.3: The methodology should be such that defined benefit members can estimate the likely level of employer-financed notional contributions for them for the year. The methodology should enable this estimate to be made *at the start of the year.*

Much resentment against the surcharge arose because the methodology resulted in surcharge assessments which were clearly inequitable. Wherever a simple formula is adopted, inequities are likely to occur in a small number of cases. However, there should be a review mechanism which can remove any resulting inequities.

Recommendation 1.4: A review mechanism should be available so that members who are unfairly affected by the methodology can request a review to take into account their specific circumstances.



Section 2: Possible Methodologies to Calculate Notional Contributions

Various methodologies could be adopted to calculate the notional contributions. We analyse some of them in this section. Firstly, however, we consider some examples from overseas where similar calculations are necessary.

Examples from overseas

We are aware that in both the UK and Canada, it is necessary to determine notional contributions for defined benefit members.

In both these countries, the proportion of defined benefit members is significantly higher than in Australia.

Nevertheless, both these countries apply a very broad brush approach to calculating the notional contributions.

The main form of benefit in these countries is a life time pension. In both cases, the "notional contribution" is merely determined as a factor times the pension accrual rate times salary. The factor is 10 in the UK and 9 in Canada.

Note that the notional contribution can be determined readily by the fund. No actuarial involvement is required.

The factor is a broad attempt to convert the pension benefit to a lump sum and hence equate it to the contributions necessary to fund it, irrespective of the actual level of contributions paid. Whilst the factor would have initially been determined using actuarial assumptions, there is no explicit allowance for any assumptions in the calculation process.

As a result, the calculation process is relatively straightforward.

Recommendation 2.1: A straightforward approach similar to that used in the UK and Canada should be adopted. (The actual mechanisms are discussed below.)

System Requirements

In comparing the possible methodologies that could be adopted in Australia, we believe that the following system characteristics should be taken into account:

- Efficiency – the maximum limit is likely to affect only a relatively small number of members and therefore the administrative costs need to be minimised. It should not be administratively costly for funds, members or the ATO;
- Forward looking – it should be possible to calculated the notional contribution as at the start of the year;
- Equity – it should be equitable (as well as perceived to be equitable) between members and as an individual's circumstances change;
- Consistency – it should provide a broadly consistent result when compared to a member receiving similar benefits through an accumulation arrangement; and
- Robustness – it should prevent, as far as possible, any manipulation.

In the rest of this section, we have analysed five possible methods and rated them against the above desired characteristics.

The various methods we have considered are as follows:

1. Accrual rate method with review mechanism
2. Accrual rate method
3. Vested benefit method
4. Minimum benefit method
5. Surcharge method

In our view, the first method, which uses the accrual rate method with a review mechanism, is the most appropriate method, outscoring the other methods using our rating scale.

Method 1: Accrual rate method with review mechanism

This is our preferred method and involves two steps.

STEP 1:

The notional contributions would be determined using a relatively simple method based on the defined benefit accrual rate. For example, the accrual rate method (which we describe in more detail under Method 2 and Appendix 1) could be used here.

This simple approach will minimise the cost impact on superannuation funds.

The main disadvantage of Method 2 (the accrual rate method) is that it could be inequitable for members in particular circumstances, as it will generally overstate the notional contribution rate.

However, we expect that most members of most defined benefit funds will not be close to the proposed $50,000 pa limit and hence any overstatement of the notional contribution will not have any adverse effect on a very high proportion of defined benefit members. If the limit is increased to $100,000 pa, then even fewer members will be affected.

In general, it will be highly paid members of generous defined benefit schemes who may be adversely impacted by the approximations in the formula.

STEP 2:

In order to make the accrual rate method more equitable for the small number of members likely to exceed the proposed concessionally taxed limit, we consider that a review mechanism should be introduced. This would enable a more accurate estimate of notional contributions to be determined for those cases for which the ATO determines that the member has exceeded the limit on concessionally taxed contributions.

In effect, we propose that the member should be able to instigate a review based on a more accurate determination.

Although such a review process will add some complexity for those who are initially determined to have exceeded the limit, it also adds considerable equity. We believe that following such a review, members will be more accepting of any resulting additional tax.

An appropriate review mechanism could be to use the vested benefit approach discussed below as Method 3. In other words, the notional contribution would be subject to a maximum that reflects the actual increase in benefit over the year (adjusted for interest).

We envisage that the member would provide information to the ATO which would enable the Method 3 "increase in vested benefit" amount to be determined. If this is lower than the amount determined under the accrual rate method, then the "increase in vested benefit" amount would be used. We would anticipate that the "increase in vested benefit"

amount would be lower in almost all cases as the formula we have suggested for the accrual rate method would generally overstate the notional contribution.

If, however, the "increase in vested benefit" amount is higher, then this would be ignored and the "original assessment" would stand. Such cases are expected to be rare.

The member would be able to apply for such a review in any year. Once the review method has been used, there would be no requirement to continue using the review method in future years.

This approach would then retain the advantages of the accrual rate method (Method 2): in particular its relative simplicity and the ability to easily estimate the notional contribution at the start of the year. The major disadvantage of that method, its inequity, would be offset by the review mechanism.

Method 2: Accrual rate method

This method is similar to the method adopted by both the UK and Canada. Because the Australian system is more flexible, with lump sum and pension options and guaranteed minimum benefits for SG purposes which underpin the defined benefit, some additional adjustments may need to be built in.

Notional contributions would be calculated using the following formula:

NC = AR x S x t/365

Where:

NC	= notional contribution
AR	= accrual rate per annum
S	= Salary used for defined benefit purposes at start of year
t	= number of days of membership during the year

In its simplest form, the notional contribution would be equal to the retirement benefit accrual rate times salary at the start of the year times the relevant portion of the year (to allow for new members and exits during the year) with an adjustment for any after tax contributions made by the member.

In order to keep the method simple, we have deliberately avoided adjustments in the formula to allow for:

- The impact of tax on employer contributions;
- Fees and charges met by employer contributions;
- Any after tax contributions made by members to help fund the benefit (we expect that of the proportionately small number of members likely to exceed the limit, a significant proportion will be contributing using salary sacrifice arrangements rather than after tax contributions). Alternatively the accrual rate could be reduced by the member contribution rate where member contributions are made on an after tax basis;
- Different final average salary periods (most defined benefit funds determine retirement benefits as a multiple of final average salary). Final average salary might normally be the average of salary received in the 3 years before retirement but longer or shorter averaging periods (or in fact no averaging) may apply;
- The probability that many members will not reach the fund's retirement age and will receive a resignation benefit which is likely to have a lower value;
- The discounting effect – the investment return on contributions made is likely to exceed the percentage growth in the accrued benefit.

If explicit allowance were to be made for the above items, only the first, contribution tax, and to a lesser extent, fees and charges, would be likely to result in an increase in the notional contribution. The other items would be likely to reduce the notional contribution. Overall we would expect that our proposed formula would overstate the notional contribution.

This method is described in detail in Appendix 1 where we also explain how AR could be adjusted to allow for:

- Any minimum benefit underpinning the defined benefit;
- Pension options (with these being valued using a fixed factor as in the UK and Canada).

Other complicating factors could involve adjustments (see Appendix 1 for suggested approaches) for cases where:

- A member changes benefit category during the year;
- Benefits are augmented during the year; or
- Benefits are increased during the year.

Nevertheless the method is reasonably simple and could, in most cases, be applied by the trustee **without** the need for actuarial advice.

The notional contribution rate would effectively be standard for each membership category with the same accrual rate and could be explained to members reasonably easily. By basing the notional contribution on the salary at the start of the year, it would be possible for members to estimate their notional contribution for the year (at least on the assumption that they do not leave their employer or change category during the year).

On the other hand it is likely to be less equitable than the approach used for surcharge as only one factor for each category would apply, rather than a variety of factors under the surcharge methodology.

As indicated above, it is likely to overstate the notional contribution, particularly for younger members (in comparison to an accumulation scheme providing similar benefits). A discount factor of say a flat 80%, or perhaps an age based scale, could be introduced. However this adds complexity, and particularly if an age based scale is used, the communication to members becomes significantly more complex and costly.

The opportunity for members/employers to manipulate the system is limited. The most obvious manipulation would be for the member/employer to significantly understate the salary used for superannuation purposes during the early years of membership and then increase salary to the full level in the period prior to retirement. This would be unlikely to occur.

Whilst such manipulation could result in reducing the additional tax payable, it would also have other adverse consequences for the employer and member.

In particular, the member's benefit security could be jeopardised – particularly if he/she left employment before the "superannuation" salary had been reinstated to the full level. Death cover may also be adversely affected.

From the employer's point of view, it may result in funding shortfalls when the member retires unless a surplus was built up in the fund with the expectation of using it to finance

the expected large increase in benefits that would result from the large salary increases prior to retirement.

Taking the risks into account, we do not believe that any significant manipulation would occur.

In any event, the restrictions on small defined benefit funds and the reporting requirements in company accounts will severely limit the ability of employers to establish defined benefit plans for manipulation purposes.

Method 3: Vested benefit approach

Under this method, the notional contribution would equal the growth in the vested benefit (grossed up to allow for contribution tax).

In a simple case, the notional contributions would be determined as follows:

$$NC = \{VB1 - VB0 \times (1 + i) - MATC \times (1 + i/2)\}/0.85$$

Where

NC	= notional contribution
VB1	= vested benefit relating to defined benefit component as at end of year
VB0	= vested benefit relating to defined benefit component as at start of year
i	= an assumed investment return set by the Government to reflect an assumed long term investment rate
MATC	= member after tax contributions made during the year

In a more complex situation, further adjustments would need to be made to take into account:

- any partial withdrawals from the fund (eg Family Law splits, portability transfers*, contribution splits*, payments of additional tax etc);
- any amounts rolled or transferred into the fund;
- any pension payments made (including transition to retirement pensions) etc.

(* Portability and contribution splitting are generally available only in respect of accumulation interests and so could generally be ignored.)

To determine the notional contribution in this way would be a complex task for funds and would seem to be overly complex for the significant majority of defined benefit members who will not be anywhere near the proposed limit.

We acknowledge that the above approach ignores fees and insurance costs. As these are generally minor, they could either be ignored (our preferred approach) or deemed to be a fixed amount of, say ½% of salary pa.

This method does not really meet the simplicity test and would involve considerable work for funds if they were required to determine this information for all members. The need to perform the calculations each time a member left the fund would add to the complexity.

In most cases, it will also be difficult for members to estimate the notional contribution at the start of the year.

Equity is also an issue. In some years, a member's benefit may jump considerably. For example, when a member reaches early retirement age, the member's benefit may automatically jump from a comparatively low resignation benefit to a much higher retirement benefit. This may result in a considerable additional tax in that year even

though the average contribution over a number of years was significantly below the proposed limit.

Other examples of inequity would apply where a member becomes disabled and a higher invalidity benefit (incorporating an "insured" component) becomes payable. In effect, the additional tax could apply to most of the "insured" component of the member's benefit. This issue could also arise on death. It would be necessary to make further adjustments for such cases – if not, then the treatment of insured amounts would be very inequitable compared to the treatment of accumulation benefits.

Where the defined benefit actually payable is based on an accumulation of contributions with interest (for example as a minimum benefit), the method may also give inequitable results. For example, in a year of high investment returns, the minimum accumulation style benefit may increase considerably. The adjustment for interest in the formula above is based on a long term rate set by the Government and if this is considerably lower than the actual return, the formula will produce an inappropriately high notional contribution.

Any risk that this method would be manipulated is unlikely to be significant. It could only be manipulated by arranging the benefit design to provide a low vested benefit with a much higher relative retirement benefit. This would result in deferral, rather than avoidance, of tax. Members would be at risk if they were to resign and only become entitled to the low resignation benefit. Therefore members may be unlikely to support such manipulation.

Review mechanism

However, whilst we believe that it would be difficult for funds to report notional contributions using this method, we believe that it would be relatively simple to implement as a review mechanism as outlined under our preferred Method 1. This is because:

It will only be necessary to calculate for a small number of cases (ie those who exceed the limit based on the approximate formula proposed under Method 1);

For funds which balance on 30 June, VB1, VB0 and MATC would all be shown on the member's annual benefit statement together with other transactional details about payments in and out. (In some cases, the vested benefit shown on the benefit statement would include any additional accumulation interest but there would generally be sufficient information on the statement to enable the vested benefit relating to the defined benefit component to be ascertained);

In those years where the vested benefit method produces an inequitable result (eg when there is a significant jump in benefits due to say reaching early retirement age or when an insurance claim is made), the review mechanism would not be applied and notional contributions would be determined using the approximate formula proposed under Method 1.

There may be some cases where the necessary data is more difficult to access. These include:

- Cases where there is a defined benefit pension in payment at the time. This could arise either because the member retired during the year and commenced the pension, or because the member is receiving a transition to retirement pension. In these cases, the vested benefit may not be shown and a value would need to be placed on the pension.

- Funds which balance on a date other than 30 June. The annual benefit statement will not show the relevant details. However, the fund would be able to charge members a fee for providing the relevant information – similar to the fees that can be charged for Family Law information requests.

We highlight again that it is likely that these review calculations would only be required for a relatively small number of defined benefit members.

Method 4: minimum benefit approach

As, in many cases, the actual benefit a member can receive is unknown until the member retires or resigns, consideration could be given to only taking into account (for the purposes of the notional contribution) the minimum benefit that the member is entitled to receive. In general, the minimum benefit a member can receive is that specified in the fund's benefit certificate prepared for the purposes of the SG legislation.

For example:

$$NC = NECR \times S \times t/365$$

Where

NC	= notional contribution
NECR	= notional employer contribution rate specified in fund's Benefit Certificate
S	= Salary used for defined benefit purposes at start of year
t	= number of days of membership during the year

This should mean that the notional contribution will always be equal to or understate any more accurately determined notional contribution.

This is considerably simpler than the other methods discussed and because of its simplicity should not be ignored. It would also enable members to readily estimate their notional contributions at the start of each year.

However, the concern may be that the formula will understate the true result in many cases.

This could lead to inequities with members of accumulation schemes and the opportunity, at least for large employers, to set up defined benefit schemes with generous benefits where the costs significantly exceed the NECR.

Method 5: Surcharge Approach

Notional contributions would be calculated in the same manner as for the superannuation surcharge.

This approach is highly complex and involves considerable actuarial work. It results in a series of multi-dimensional tables of notional contribution factors which can depend on the member's age, sex and period of membership.

Due to the complexity of these tables, it would be very difficult for trustees to provide a simple communication to members to enable them to estimate the notional contribution in at the start of each year.

The factors are based on a set of assumptions which can and have been challenged by aggrieved members, generally on the basis that these assumptions do not reflect their own circumstances. These challenges have arisen even though the Surcharge Regulations have, at least in recent years, specified how the assumptions were to be determined.

Despite the multiple factors being designed to provide the greatest equity possible within the legislative constraints, the factors regularly produced inequitable results when compared to the actual benefits received.

However, it is noted that this method, albeit complicated, costly, often inequitable and difficult to communicate, has operated in recent years.

Comparison of methods

In the following table we have rated the various methods proposed above against the various criteria.

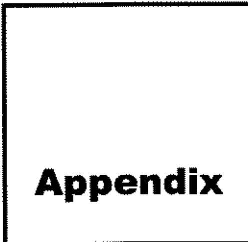
Rating	Interpretation
5	The highest rating. The method meets the relevant requirement.
4	The method meets most aspects of the relevant requirement.
3	The method meets approximately half of the relevant requirement.
2	The method meets only a small proportion of the relevant requirement.
1	The lowest rating. The method is unsatisfactory.

	Method 1 (accrued with review)	Method 2 (accrued)	Method 3 (vested)	Method 4 (minimum)	Method 5 (surcharge)
Efficiency	3	4	2	5	1
Forward looking	4	4	1	5	2
Equity	4	3	4	1	3
Consistency	4	2	4	1	2
Robustness	4	4	4	2	4
Total	**19**	**17**	**15**	**14**	**12**

Notes:
Efficiency – minimisation of administrative costs for funds members and the ATO.
Forward looking – the ability to calculate the notional contribution at the start of the year.
Equity – between members and as an individual's circumstances change.
Consistency – with members receiving similar benefits through accumulation funds.
Robustness – prevention of manipulation.

Clearly no method is ideal. However we consider that Method 1 provides a satisfactory result against all criteria, with Methods 3, 4 and 5 failing in at least 2 areas.

Recommendation 2.2: Notional contributions should be determined using a standard simple formula based on the retirement benefit accrual rate as outlined in this report with a more accurate review mechanism available in cases where the contribution limit is exceeded according to the standard formula (Method 1 in this report).



APPENDIX 1: Detailed description of Method 2 – accrued benefit method (also used as Step 1 of Method 1)

The following standard formula would apply:

NC = AR x S x t/365

Where:

NC	= notional contribution
AR	= accrual rate
S	= Salary used for defined benefit purposes at start of year
t	= number of days of membership during the year

As indicated in Section 2 of the report, the formula deliberately ignores any direct reference to:

The impact of tax on employer contributions;
Fees and charges met by employer contributions;
Any after tax contributions made be members to help fund the benefit (we expect that of the proportionately small number of members likely to exceed the limit, almost all will be contributing using salary sacrifice arrangements rather than after tax contributions);
Different final average salary periods (most defined benefit funds determine retirement benefits as a multiple of final average salary. Final average salary might normally be the average of salary received in the 3 years before retirement but longer or shorter averaging periods (or in fact no averaging) may apply). The method would result in the same notional contribution, irrespective of whether the scheme uses a 5 or 3 year final average salary period or, in fact, uses final salary for benefit purposes;
The probability that many members will not reach retirement age and will receive a resignation benefit which is likely to have a lower value;

The discounting effect – the investment return on contributions made is likely to exceed the percentage growth in the accrued benefit.

The combined impact of these omissions would generally be to overstate the notional contribution.

However, the Government could, if it wished, decide to refine the formula slightly by, for example, adding adjustments for;

After tax member contributions;

A factor of, say 80% to allow (very broadly) for the discounting effect.

Any such adjustments would however add to the complexity.

Lump sum defined benefit plan

In this case, AR would be calculated as the lump sum accrual rate applicable assuming that retirement occurs at age 65 or, if the fund imposes an earlier compulsory retirement age, the age of compulsory retirement.

Lump sum defined benefit plan with defined pension option

The same formula as shown above would apply except that:

AR = the greater of:
(a) LSAR; and
(b) 10 x f x LSAR/CF + LSAR x (1-f)

LSAR = the lump sum accrual rate as determined above
f = the maximum proportion of the lump sum that can be converted to a pension
CF = the factor used to convert a lump sum to a pension at age 65 (or earlier compulsory retirement age).

(The factor of 10 used to determine the pension accrual rate is somewhat arbitrary and could be replaced by some other number. It is consistent with the factor used in the UK and higher than that used in Canada. However it is important to keep it simple with one factor applying to all defined benefit pensions. Applying different factors for the many varied forms of pension with differing indexation rates, differing reversionary pension formula, different guarantee periods etc should be avoided.)

Defined pension plan

The same formula as shown above would apply except that:

MAR = the greater of:
(a) 10 x PAR; and
(b) CF x f x PAR + 10 x PAR x (1-f)

PAR	= the pension accrual rate applicable assuming that retirement occurs at age 65 or, if the fund imposes an earlier compulsory retirement age, the age of compulsory retirement.
f	= the maximum proportion of the pension that can be converted to a lump sum
CF	= the factor used to convert a pension to a lump sum at age 65 (or earlier compulsory retirement age).

Plan with fully vested accumulation minimum

For simplicity, we would prefer that no adjustment is made for such minimum accumulation benefits. However, the Government could consider requiring that the notional contribution be determined as the greater of NC as calculated above and the amounts allocated to the minimum accumulation benefit account.

For example, defined benefit funds which are used to meet an employer's Superannuation Guarantee obligations are required to establish a *minimum* benefit formula. This formula is often determined on an accumulation basis. However it would be extremely rare for the contributions allocated to the minimum benefit account to exceed the accrual rate. Ignoring the minimum would therefore have no significant impact on revenue.

Allowance for such a minimum should only be made if the Government is concerned that the method could be "rorted" by setting an arbitrarily low retirement accrual rate which could be subject to a significant accumulation style minimum benefit.

In our view, we consider that such rorts are unlikely. Whilst the formula could readily be adjusted to include allowance for such a minimum benefit, we would prefer that the added complexity only be introduced if there is evidence of abuse.

Plan with partially vested accumulation minimum

A similar approach could be adopted where only part of the contribution to the minimum benefit account is vested. If the Government considers it necessary, the notional contribution could be determined as the greater of NC as calculated above and the amounts allocated to the minimum benefit account including 100% of any amounts allocated that are only partially vested.

Defined benefit plan where different accrual rates apply to different membership periods

Some examples of such circumstances include:

- Members are allowed to switch from one membership category to another;
- Members reach the maximum multiple allowed under the scheme's rules;
- Different accrual rates apply to different periods of service (for example a higher accrual rate might apply in the first 20 years of service);
- Member changes contribution basis from after tax to before tax during the year;

- Benefits for future service are increased during a year.

In these cases, each period would be treated separately and then combined, although the method could be simplified by ignoring any such changes during the year.

Defined benefit plan where only part of employer contribution results in a defined benefit component

The above formula would apply but it would be necessary to add on any other employer contributions made to an accumulation arrangement.

Benefit augmentations

Where a benefit is augmented at the time of exiting the fund or leaving the employer's service, an additional notional contribution can arise. (This could also occur when a benefit is crystallised, for example when contributions for the member cease.) For a lump sum scheme, this could be calculated as:

(Total benefit payable – greater of vested benefit and accrued retirement benefit calculated immediately before augmentation)/ 0.85
(subject to a minimum of zero)

A similar approach could be adopted for pension schemes.

Benefit changes

Where a member's accrued benefits are increased during the year due to a change in the scheme's rules, an additional contribution can arise. For a lump sum scheme, this could be calculated as:

(Greater of accrued retirement benefit and vested benefit immediately after the improvement; less
Greater of accrued retirement benefit and vested benefit immediately before the improvement)/ 0.85

A similar approach could be adopted for pension schemes.

Defined benefits not related to salary or final average salary

There may be some, but very few, defined benefit plans where the defined benefit is not dependent on the member's salary or final average salary. For example, the defined benefit may be determined as $1,000 for each year of membership.

It would be possible to specify a formula for some possible benefit designs, although due to the potential variety of benefit designs it is unlikely that all could be foreseen when drafting the legislation. It may be preferable for the legislation to require funds which

provide non-salary based accruing benefits to apply to the ATO for approval of a special method.

Generally such schemes apply to lower income employees so that members are unlikely to be affected by the limits. A simple approach should therefore suffice.

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