MERCER
Human Resource Consulting

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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. 7 – Employer Eligible Termination Payments

Dear Sir

This is the 7th 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

- A change to the taxation treatment of employer eligible termination payments (ETPs); and
- The removal of the ability to rollover employer ETPs to a superannuation fund.

Executive Summary

We can understand the reasoning behind the Government's proposals regarding employer ETPs, however there are a number of issues we believe need to be considered before finalising the Government's Plan.

In this report we have:
- Highlighted the significant incentives for senior executives to retire before 1 July 2007 as a result of the taxation and rollover changes and made suggestions on how this could be handled;
- Recommended that the tax on employer ETPs be limited to a maximum of the tax that would have applied if the ETP had been taxed as normal income;
- Recommended that it be possible to rollover a maximum of $50,000 of the post-June 1983 component of an employer ETP;
- Recommended that all employer ETPs paid on death be tax free;
- Recommended that the low-rate tax threshold for employer ETPs be set equal to the tax-free threshold applied to lump sum post-June 1983 superannuation benefits; and

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Recommended that the low-rate tax threshold for employer ETPs be indexed annually in line with increases in Average Weekly Ordinary Time Earnings.

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.

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 Employer ETPs

Recommendations		Government Discussion Paper Reference
Impact on Early Retirement/Termination – Refer to section 1 of attached report		
1.1	The Government should give further consideration to the tax treatment of employer ETPs and the decision to prevent the rollover of employer ETPs from 1 July 2007, in order to reduce the incentive for senior executives to leave service early. We have outlined some possible methods for consideration in the attached report.	7.1.2
Tax Rate Applied to Employer ETPs – Refer to section 2 of attached report		
2.1	The tax applicable to employer ETPs should be calculated assuming the taxable portion of the ETP is normal assessable income, but subject to a maximum tax rate of 15% on the first $140,000 and 45% on the remainder.	7.1.2
Rolling Over of Employer ETPs – Refer to section 3 of attached report		
3.1	A person entitled to an employer ETP should be permitted to roll over up to $50,000 of the post-June 1983 component to a superannuation fund. Any amount rolled over will not count towards the $140,000 low-rate tax threshold. Nor would it be taken into account for the purposes of the limits on concessionally taxed deductible contributions or undeducted contributions.	7.1.2
Tax on Employer ETPs Paid on Death – Refer to section 4 of attached report		
4.1	All employer-paid lump sum death benefits should be tax free.	7.1.2
4.2	The tax treatment of employer-paid pension death benefits should be the same as for pensions paid from untaxed superannuation funds on death.	7.1.2

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Other Issues – Refer to section 5 of attached report		
5.1	The low-rate tax threshold for employer ETPs should be set equal to the tax-free threshold applied to lump sum post-June 1983 superannuation benefits.	7.1.2
5.2	The low-rate tax threshold for employer ETPs should be indexed annually in line with increases in Average Weekly Ordinary Time Earnings.	7.1.2
5.3	The issue of whether each employer ETP is assessed separately against the low-rate tax threshold, or whether employer ETPs are aggregated over a person's lifetime for assessment against the threshold, should be clarified.	7.1.2
5.4	The pre-July 1983 component of an employer ETP should be determined at the date of payment of the benefit.	7.1.2

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
Submission No. 6 – Defined Benefit Funds	9 August 2006

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A Plan to Simplify and Streamline Superannuation

Submission No 7: Employer Eligible Termination Payments

The Treasury

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1

Impact on Early Retirement/Termination

It has been proposed that the tax treatment of employer eligible termination payments (ETPs) will be changed from:

Component	**Assessable Portion**	**Proposed Tax Treatment**
Post June 1994 invalidity component	Not assessable	Exempt
Pre-July 1983 component	5%	Marginal rates
Post-June 1983 component (untaxed)	100%	Under age 55 – 30% Under age 55 Up to threshold – 15% Over threshold – 30%
Excessive component (above RBL)	100%	47%

to:

Component	**Assessable Portion**	**Proposed Tax Treatment**
Post June 1994 invalidity and pre-July 1983 amounts	Not assessable	n/a
Taxable	100%	Under age 55 Up to $140,000 – 30% Over $140,000 – top MTR[1] Age 55 and over Up to $140,000 – 15% Over $140,000 – top MTR[1]

[1] Marginal tax rate

The proposed changes mean that there will be a significant financial incentive for senior executives entitled to a payment from their employer on termination to terminate their employment early, prior to 1 July 2007.

For example, a person receiving an employer payment after 1 July 2007 will be taxed at 45% on the excess over $140,000. If they terminate service prior to 1 July 2007, roll over their payment to a superannuation fund and leave it in the fund until some time after 1 July 2007, the only tax incurred (assuming they are over 60 when they take their benefit) will be the 15% deducted from the post-June 1983 component on rolling over the benefit to the fund. In other words, there is effectively a 30% tax differential applying on the portion of employer ETPs in excess of $140,000 received before 1 July 2007, compared to the treatment if received on or after 1 July 2007.

Even if the person does not want to roll over their benefit, there is the potential for a significant tax differential. If the person receives an employer ETP in cash, and it is within their Reasonable Benefit Limit (RBL), the current rules provide for the benefit to be taxed at a maximum of 30%. However, under the proposed system, the amount of the employer ETP in excess of $140,000 would be taxed at 45%, even if this is under the old RBL. So in this situation the person incurs additional tax of at least 15% on the excess over $140,000 on taking their benefit in cash after 1 July 2007.

There is therefore a very definite incentive to leave employment before 1 July 2007 in these situations. This could have the effect of severely disrupting business if a significant number of senior executives retire before 1 July 2007 to take advantage of the current treatment of employer ETPs.

We note that this window of opportunity is partly caused by the changes to the treatment of employer ETPs post 30 June 2007, but also due to the proposed changes to superannuation (ie the removal of tax from age 60 and the removal of RBLs) which make the current roll-over option very attractive.

Recommendation 1.1: The Government should give further consideration to the tax treatment of employer ETPs and the decision to prevent the rollover of employer ETPs from 1 July 2007, in order to reduce the incentive for senior executives to leave service early. We have outlined below some possible methods for consideration.

Stop rollovers before 1 July 2007

The Government could announce, in November or December 2006, that the following changes to the proposals are to apply:

a. Any further rollovers of employer ETPs are not permitted from the date of the announcement of the change (ie from November/December 2006, rather than from 1 July 2007);
b. The excess of employer ETP payments over $700,000 (approximately the current lump sum RBL) is to be taxed at 45%;
c. The amount under $700,000 is to be taxed at 15% (30% for those under 55); and

d. The $700,000 threshold is to be gradually reduced to $140,000 over a period of, say, 6 years (so that after this time the whole amount over $140,000 is taxed at 45%).

Stop rollovers before 1 July 2007 – Alternative

Again, the Government could announce (in November or December this year) changes to the proposals. Items (a), (b) and (c) are the same as above but part (d) is varied to:

d. The tax rate on the amounts between $140,000 and $700,000 is to be gradually increased from 15% (30% for those under 55) to 45% over a period of 6 years (so that after this time the whole amount over $140,000 is taxed at 45%).

Both of these options implement the changes outlined in the proposals, but the full effects are introduced more gradually. Both would prevent a person from rolling over an employer ETP prior to 1 July 2007 and hence alleviate the issue of senior executives terminating their employment early identified above. Also, the increase in tax is introduced more gradually, which gives individuals a certain amount of lead time to plan for the changes.

Increase rollover tax

A third alternative could be to continue to allow employer ETPs to be rolled over until 30 June 2007, but to increase the tax on the taxable amount of the rollover from 15% to 30%. However, this does not completely solve the transitional problem. There will still be a significant incentive for those with potentially large ETPs to retire early, prior to 1 July 2007, although the tax differential is reduced to 15%, rather than 30%. It also adversely affects lower to middle income earners receiving an employer ETP as the rollover tax would double overnight. However, many of these people would be no worse off than they would have been before the Budget, where a combination of the 15% tax on rollovers and the further tax on the benefit (in excess of the tax free threshold) would have resulted in a total tax of 30% anyway.

2

Tax Rate Applied to Employer ETPs

Section 159SA of the Income Tax Assessment Act 1936 currently ensures that the tax paid on employer ETPs is no greater than that calculated on the rates shown below:

Component	Assessable Portion	Proposed Tax Treatment
Post June 1994 invalidity component	Not assessable	Exempt
Pre-July 1983 component	5%	Marginal rates
Post-June 1983 component (untaxed)	100%	Under age 55 – 30% Under age 55 Up to threshold – 15% Over threshold – 30%
Excessive component (above RBL)	100%	47%

This means that the tax paid on an employer ETP is the lesser of the tax calculated on these rates and the amount of tax that would have been incurred if the benefit had been paid as normal income (ie as additional salary or as a bonus).

The following table compares the tax that would be deducted from a payment of normal income, and the tax that would be deducted from an employer ETP under the Government's proposal (if no maximum is applied). For this purpose it is assumed that the person receives no other income during the year and is aged under 55.

Payment	Tax – Normal Income	Tax – Proposed Basis for Employer ETPs
$6,000	$0	$1,800
$25,000	$2,850	$7,500
$75,000	$17,850	$22,250
$125,000	$37,850	$37,500
$140,000	$43,850	$42,000

The above table shows that a person entitled to an employer ETP on termination of less than about $125,000 would be better off accepting a payment of additional salary or a bonus prior to termination than the ETP, if the ETP tax is not limited to a maximum of that which would have applied if the ETP was treated as taxable income. (If other income were taken into account, the point at which accepting additional salary was more beneficial than an employer ETP would be lower).

Employers may therefore face pressures to make payments of additional salary or bonuses rather than ETPs in some cases. This could have the result of increasing other employer costs that are based on salary (superannuation contributions, leave entitlements, etc).

Recommendation 2.1: The tax applicable to employer ETPs should be calculated assuming the taxable portion of the ETP is normal assessable income, but subject to a maximum tax rate of 15% on the first $140,000 and 45% on the remainder.

3

Rolling Over of Employer ETPs

We believe that there are grounds to continue to allow at least some part of an employer ETP to be rolled over. This would allow recipients more flexibility to decide how to receive their payment.

Consider the scenario of a person less than age 55 who receives a modest employer ETP (ie less than the $140,000 threshold) due to disability. Under the proposed rules, the person would pay tax of 30% on the taxable portion of the payment. If they were able to roll over the payment to a superannuation fund, they would incur 15% tax on entry to the fund, but the benefit may well be tax free if they leave it in the fund until age 55 and their total superannuation benefit is less than the tax-free threshold, or if they leave it in the fund until age 60. The person therefore incurs additional tax of up to 15% on such payments even though the person may have no control over their disability or termination of employment.

There may therefore be situations where an employer feels a moral obligation to keep such an employee "on the books", until after age 55.

A similar situation could also arise in relation to a redundancy program. The proposed tax differential on bona fide redundancy payments (over the tax-free amount) between those over age 55 and under age 55 may result in tension and pressure from employees and unions to provide a higher redundancy benefit to those under age 55.

It is noted that the Government's decision to prevent the rollover of employer ETPs is designed to stop a person reducing tax on their benefit by rolling it over to a superannuation fund and taking it tax free after they reach age 60. However, we believe that allowing a person to roll over a modest part of the taxable portion of an employer ETP will ease the problems highlighted above without affecting tax revenue significantly.

A limit of $50,000 should eliminate the majority of the problems for low to middle income earners. For simplicity we recommend that the amount rolled over does not count towards the $140,000 threshold for employer ETPs taken as cash. Nor should it count towards the limits on concessionally taxed deductible contributions or undeducted contributions.

This means that up to $50,000 of the post-June 1983 component of an employer ETP would be taxed at 15% rather than at 45%, but we do not believe that this would have a significant impact on tax revenue.

Recommendation 3.1: A person entitled to an employer ETP should be permitted to roll over up to $50,000 of the post-June 1983 component to a superannuation fund. Any amount rolled over will not count towards the $140,000 low-rate tax threshold. Nor would it be taken into account for the purposes of the limits on concessionally taxed deductible contributions or undeducted contributions.

4

Tax on Employer ETPs Paid on Death

The Government's proposal does not specify how an employer ETP paid as a lump sum following the death of an employee is to be taxed.

Currently, if the benefit is paid to a dependant, it is tax free within the pension RBL of the deceased. However, a payment to a non-dependant is assessable as an ETP and taxed at 30%. Any excessive component is taxed at 47% plus Medicare levy. It is not clear what the tax treatment will be in the future given RBLs will no longer exist.

In Submission No. 4 on benefit taxes, we recommended that all lump sum death benefits and reversionary pension benefits should be tax free. Among other advantages, this would remove the complexities involved in determining if a beneficiary is a dependant or non-dependant. These complexities also exist when an employer makes a payment on the death of an employee.

We therefore believe that all lump sum employer ETPs paid on death should also be tax-free. This would make the tax treatment more consistent with superannuation death benefits.

Recommendation 4.1: All employer-paid lump sum death benefits should be tax free.

We understand that some employers pay ex-gratia pensions to former employees, or following an employee's death, to the spouse. Our view is that these should be taxed in a manner that is consistent with the tax treatment of a pension paid by an untaxed superannuation fund on death.

Recommendation 4.2: The tax treatment of employer-paid pension death benefits should be the same as for pensions paid from untaxed superannuation funds on death.

5

Other Issues

Low-Rate Tax Threshold

It has been proposed that the low-rate tax threshold for employer ETPs be set at $140,000. This compares to the tax-free threshold for lump sum post-June 1983 superannuation benefits of $135,590 (for 2006/07).

We recommend that the low-rate tax threshold for employer ETPs be set at the same level as the tax-free threshold for superannuation benefits paid to those under age 60. This adds to the simplification of the proposals, rather than having different thresholds for employer ETPs and superannuation benefits.

Recommendation 5.1: The low-rate tax threshold for employer ETPs should be set equal to the tax-free threshold applied to lump sum post-June 1983 superannuation benefits paid to those under age 60.

Indexation of Low-Rate Tax Threshold

All dollar amounts should be indexed annually, in line with increases in Average Weekly Ordinary Time Earnings, as currently applies to the tax free threshold and RBLs. This is consistent with our recommendations for the indexation of the contribution limits.

Recommendation 5.2: The low-rate tax threshold for employer ETPs should be indexed annually in line with increases in Average Weekly Ordinary Time Earnings.

Aggregation of Employer ETPs

We note that the Government's proposal contains the comment that there would be no lifetime limit on concessionally taxed employer payments, and as a result employers would not be required to report employer ETPs to the ATO.

It therefore appears that there will be no aggregation of employer ETPs paid during a person's lifetime for comparison with the low-rate tax threshold. Each payment will be separately compared with the threshold to determine the tax payable. However, we recommend that this issue be clarified.

Recommendation 5.3: The issue of whether each employer ETP is assessed separately against the low-rate tax threshold, or whether employer ETPs are aggregated over a person's lifetime for assessment against the threshold, should be clarified.

Pre-July 1983 Components of Employer ETPs

The Government's proposal will require the pre-July 1983 component of superannuation benefits to be fixed at a particular date, for inclusion in the exempt component of the benefit. However, it is not clear whether the intention is to fix the pre-July 1983 component of an employer ETP at, or near, 1 July 2007. We note that it will not be possible to do this for most employer ETPs, as the amount of the ETP will not be known until the payment is made. We recommend that the pre-July 1983 component be determined at the date the employer ETP is paid, based on the amount of the benefit at that date.

Recommendation 5.4: The pre-July 1983 component of an employer ETP should be determined at the date of payment of the benefit.

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