



THE MAY ECONOMIC STATEMENT REVISITED

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INTRODUCTION

Our previous briefing paper outlined the major changes affecting superannuation as detailed in the May Economic Statement. The purpose of this paper is to provide further details on the more important changes, consider the impact on funds and investigate the actions that may need to be taken by Employers and Trustees.

I. TAX ON INVESTMENT INCOME

The 15% tax on investment income and real capital gains, offset by imputation credits for franked dividends, is a completely new tax. It is the first time superannuation funds in Australia have been subject to a tax on income.

The effect of the tax will vary depending upon the asset profile of the investment medium. The effective rate of tax will be lower for funds with a higher exposure to Australian equities providing franked dividends than funds with little or no exposure to equities. Much will depend on what adjustments investment managers make to their portfolio structure, which will not be clear for some time.

Whilst the expectation of Treasury is that the tax on investment income will be largely offset by the imputation credits, the view of the industry is that this will not be the case in many instances, particularly for capital guaranteed and capital stable contracts.

In an *accumulation plan* the effect of the tax on investment income is estimated (on conservative assumptions) to reduce benefits as follows:-

Effective Rate of tax	Reduction in final benefit after		
	20 Yr's	30 Yr's	40Yr's
5%	4.6%	7.0%	9.3%
10%	9.0%	13.3%	17.6%
15%	13.1%	19.2%	25.0%

In a *defined benefit plan* the impact will result in increased employer contributions if no change is made to the level of benefits.

Many questions remain unanswered as to the application and administration of tax. Despite an effective date of **1st July 1988** the legislation will not be presented to Parliament until the next session commencing in August and could meet with opposition in the Senate.

It is anticipated that in most cases investment managers will reflect the tax payable, including any provision for tax on unrealized capital gains, in their unit pricing or rate declarations for pooled vehicles.

Action:

1. Trustees should confirm whether their investment manager's asset mix is still compatible with the Trustees risk/return profile. If the manager has increased equity exposure more than the Trustees deem suitable, consideration should be given to a manager with a lower equity exposure. If volatility in returns is of little concern, a higher equity exposure with its resultant tax benefits and higher expected return in the long term may be acceptable.
2. If, as discussed below, an employer is planning to reduce the future service benefit accrual rate in a *defined benefit plan* due to the impact of the tax on employer contributions, allowance may be made for the estimated impact of the tax on investment income.
3. In an *accumulation plan* the tax on investment earnings will automatically impact on member benefits. An increase in employer contributions would be required if the employer wished to bear the effect of the tax on investment earnings rather than see members' benefits diminished.
4. For Trustees undertaking their own investment, assets will need to be valued at 30th June 1988 for capital gains tax purposes. Systems will need to be introduced to calculate the tax liability.

Provisions for payment of the tax will need to be created.

2. TAX ON BENEFITS

The lump sum tax on benefits is to change from 1st July 1988 as follows:-

	Old Tax Rate	New Tax Rate
Prior to age 55	31.25%	21.25%
From age 55		
- first \$60,000*	16.25%	Nil
- balance	31.25%	16.25%

* Prior to 1st July 1988 the higher rate applied from \$55,000 not \$60,000.

The above rates include the current medicare levy of 1.25%. From 1st July 1989 the threshold of \$60,000 will be indexed annually based on the movement in average weekly earnings in the year to 31st March. For benefits which relate to plan membership which commenced prior to 1st July 1987 a transitional period will apply.

Commencement of Fund Membership	End of Transitional Period
prior to 1.7.'85	30.6.'92
from 1.7.'85 - 30.6.'86	30.6.'90
from 1.7.'86 - 30.6.'87	30.6.'89

During the transitional period taxation rates will be progressively reduced from the old rates to the new rates. The reduction in rates occurring at 1st July each year during the transitional period increases the tax advantage of deferring the payment of tax until after 1st July.

Action:

Alter written material and communicate changes in taxation of benefits to members. Advise members of the effect of transitional arrangements when planning for retirement.

3. TAX ON EMPLOYER CONTRIBUTIONS

The impact of the 15% tax on employer contributions is clear and precise. From 1st July employer contributions will be reduced by a 15% tax. Tax will be determined by annual assessment and payable in the year following the year

of income, with a system of quarterly instalments commencing in 1990/91. Funds will have the benefit of investment earnings on the taxable part of employer contributions prior to the payment of the tax. All expenses can be offset against the tax, including administration costs, insurance costs and professional fees.

In an *accumulation plan* the tax on employer contributions is reflected directly in the benefit accumulating for a member. The benefit accruing from the employer contributions will thus be reduced by 15%. This is offset by the reduced lump sum tax on end benefits, hence the *after-tax* benefit in most cases will not be reduced. In fact the *after-tax* benefit will be marginally improved due to the loss of the medicare levy, the increased threshold and the removal of lump sum tax on earnings arising from member contributions.

However, some cases will occur where members with service prior to July 1983 will be worse off under the new arrangements, despite the assurance of the Treasurer that no member's benefits would be reduced by the tax on employer contributions.

The position for a *defined benefit plan* is quite different to that of an accumulation plan. Under a defined benefit plan the *pre-tax* benefit on retirement is expressed as a fixed multiple of salary, and thus will not automatically change when only 85% of the employer's contribution is available to provide the end benefits. If the employer wishes to continue to provide the same level of *pre-tax* benefits, then the employer contributions would need to increase by 17.6%, to enable the same amount of monies to be available for retirement. (The 17.6% is required because tax is paid on the 15% additional contributions).

If no change was made to the *pre-tax* benefits to be provided, members would receive a windfall gain due to the lower lump sum tax on end benefits. The Government has recognised this and noted that it may be appropriate for funds to reduce *pre-tax* benefit levels. This would ensure no change

to benefit payments after the lump sum tax. Trust Deeds almost invariably allow for a reduction in the future service benefit accrual rate, although benefits accrued to date cannot be reduced without members' consent.

The appropriate reduction in the benefit accrual rate will depend on the plan design and level of member contributions. Where all benefits, including the resignation benefit, are related to the same benefit accrual rate the following reduction in future service accrual rate would be appropriate:-

Proportion of Contributions paid by Member	Reduction in Future Service Accrual Rate
Nil	15%
1/3rd	10%
2/3rds	5%
All	0%

For example, a non contributory plan with a benefit accrual rate of 20% for each year of service would need to reduce the accrual rate by 3 percentage points (15% of 20%) to 17% for each year of membership after 1st July 1988 to ensure employer contributions would not increase. This reduction in accrual rate would also ensure members do not gain from the reduced lump sum tax on end benefits.

For convenience the reduction in the benefit accrual rate should apply to death and disablement benefits, as well as retirement benefits. However, there is no change to the taxation of death benefits making a reduction in the pre-tax benefit difficult to justify. A reduction in the accrual rate for death and disablement benefits would result in a *immediate* reduction in benefits rather than a *prospective* reduction in pre-tax benefit as is the case for retirement. This supports a maintenance of the existing accrual rate for death and disablement benefits. Thus it may be necessary to have one accrual rate for death/ disablement benefits and another accrual rate for retirement benefits, resulting in a more complicated plan design.

Action:

1. No action is required for an accumulation plan as the tax on

employer contributions is automatically offset by the reduced lump sum tax on end benefits.

2. For defined benefit plans employers need to consider a reduction in the future service benefit accrual rate for retirement, death and disablement benefit purposes. Actuarial advice will be required to determine the appropriate reduction in the accrual rate. If no such reduction is to take place, then employer contributions will need to be increased by 17.6%.
3. If a reduction in accrual rate occurs for a defined benefit plan a comprehensive communications exercise will be necessary. A similar exercise would be appropriate even if no reduction occurs as the employer is effectively increasing benefits to employees.
For all plans, and regardless of whether changes are made or not, members need to be reassured of their position.

4. REASONABLE BENEFIT LIMITS

The new Reasonable Benefit Limits (RBLs) to commence from 1st July 1988 provide for reduced maximum benefits as salary increases and apply to both pension and lump sum plans. The new RBLs will have no retrospective impact in that a benefit of 7 times final average salary can be provided for service prior to 1st July 1988.

The new RBLs are expressed as a multiple of final average salary as follows:-

Final Average Salary	RBL	
	Lump Sum Multiple	Pension Multiple
First \$35,000	7	.75
Amount between \$35,001 and \$65,000	5	.55
Amount over \$65,000	3	.35

From the 1st July 1988 the Final Average Salary thresholds will be indexed annually based on the movement in average weekly earnings

over the year ended 31st March. In contrast to the previous system, non-deductible contributions (principally member) made after 1st July 1983 are to be excluded when applying the RBLs. The exclusion of member contributions paid after 1st July 1983 from the RBL calculation, and application of the RBLs partially to after-tax benefits, will mean the new RBLs can produce higher after-tax benefits than the previous system depending upon salary and member contribution levels. For a non-contributory plan the after-tax benefit under the new RBLs will only be reduced for salaries in excess of \$70,000.

The following table illustrates the gradual effect of the RBLs on lump sum multiples dependent upon salary and service after 1st July 1988.

Lump Sum RBLs as a Multiple of Final Average Salary

Proportion of Service After	Final Average Salary (\$'000's)					
	35	65	80	100	150	200
1.7.'88						
0%	7.00	7.00	7.00	7.00	7.00	7.00
25%	7.00	6.77	6.63	6.50	6.33	6.25
50%	7.00	6.54	6.25	6.00	5.67	5.50
75%	7.00	6.31	5.88	5.50	5.00	4.70
100%	7.00	6.08	5.50	5.00	4.33	4.00

The definition of an *eligible service period* for determining the transitional arrangements is that used in the Income Tax Assessment Act for the purpose of the taxation of Eligible Termination Payments. Thus if a benefit from a previous fund has not been preserved with its attaching service prior to 1st July 1988 then the new RBLs will take effect immediately from 1st July 1988.

The application of the RBLs on commutation of a pension has also changed. Previously, up to 25% of the pension could be commuted before the lump sum maximum benefit limits were applied. Under the new arrangements up to 50% of a pension can be commuted to a lump sum benefit before the lump sum limits apply.

On a progressive basis over five years from 1st July 1990 85% of ex gratia payments made under Section 78(1)(c) of

the Tax Act which are attributable to service after 1st July 1983, will be included under the RBLs.

Benefits from non tax-concessional funds will not be subject to the RBLs. However, these funds will incur tax on employer contributions and investment income at the top personal tax rate.

Action:

1. *Commence process of redesigning senior executive remuneration packages including reconsideration of company attitude to ex gratia payments and non tax-concessional funds.*
2. *Contribution levels for accumulation funds need to be reviewed to reflect revised RBLs. The next actuarial report will take account of revised RBLs for defined benefit funds.*
3. *The effect of the revised RBLs on death and disablement benefits will need to be considered.*

5. PERMISSIBLE CONTRIBUTIONS

To provide further detail on the operation of the RBLs the Occupational Superannuation Group of the Insurance and Superannuation Commissioner has issued Information Circular No.7.

The circular notes that the "detailed arrangements on administration and implementation will be subject to review and consultation with the industry". Thus parts of the Circular may well change. Various parts of the Circular require clarification.

The Circular also revises the basis to be used for the calculation of maximum permissible contributions for **accumulation** plans. The new basis provides for an assumed long term fund earning rate of 10% per annum, compared with the previous rate of 9% per annum. The effect of this change is to reduce permissible contributions for any given level of benefit. Changes to the method of allowance for benefits previously received will also lead to a reduction in permissible contributions.

In the calculation of permissible contributions it is necessary to allow for the new RBLs. For a particular member this will be calculated using the **eligible service period** at the normal retirement date. Thus the impact of the new RBLs will be gradual for purposes of benefit payments but will be immediate for contribution purposes.

In relation to defined benefit funds it should be noted that individual member calculations are not required but permissible contributions are restricted to levels consistent with the assumptions and formulae contained in the Circular. The less conservative differential between investment returns and salary escalation increases the chance of contributions for defined benefit funds being in excess of those permissible.

Action:

1. *For accumulation plans providing maximum benefits it will be necessary to reconsider the level of benefit to be provided in view of the revised RBLs, taxation of benefits and the increased cost through taxation of employer contributions.*
2. *For accumulation plans providing maximum benefits an actuarial calculation of the permissible contributions taking into account the new basis will be required.*
3. *For defined benefit plans the actuary will need to ensure contributions recommended at the next valuation are consistent with Information Circular No.7.*

6. COMMENT

The above discussion has outlined the impact of the major changes including:-

- * the Government now has three means of taxing superannuation plans, employer contributions, investment earnings, and benefits-compared with the one avenue in the past.
- * future changes in the levels of tax will reflect automatically in member

benefits in the case of accumulation plans. Future changes to the tax on employer contributions or investment earnings would require further changes to defined benefit plans.

- * public sector superannuation arrangements will be brought into line with private sector arrangements, including reasonable benefit limits.
- * the lower levels of tax after age 55 reduce the incentive for members to preserve benefits past this age. Thus the Government has missed the opportunity to enforce greater preservation and reduce the possibility of "double dipping".
- * the imposition of reduced reasonable benefit limits for pension as well as lump sum benefits will not encourage greater use of pension benefits, which should have been one of the Government's priorities.
- * much of the detail is yet to be announced by the Government and the Insurance and Superannuation Commission. Uncertainty and administrative complexities will exist for Trustees, investment managers and administrators.
- * Information Circular No.7 issued by the Insurance and Superannuation Commission will be the subject of industry consultation and is thus likely to change. In particular, the move from a 1% p.a. differential to a 2% p.a. differential for the calculation of permissible contributions appears to take no account of the impact of the tax on investment earnings.
- * Superannuation industry bodies are seeking adjustment and deferral of parts of the changes. The authorities will be seeking co-operation from funds in the absence of legislation.

7. ACTION CHECKLIST

All Plans

- * Check whether investment manager's asset mix remains compatible with Trustees risk/return profile.

- * For self invested plans, value assets at 30th June 1988 for capital gains tax purposes and introduce systems to accommodate taxation of invested income.

- * Alter written material and advise member of changes, including the taxation of benefits.

- * Reconsider senior executive remuneration packages.

- * Alter trust deeds where necessary.

Accumulation Plans

- * The tax on investment earnings will automatically impact on member benefits. Increased employer contributions would be required if the employer wished to bear the cost.

- * No action is required to ensure the tax on employer contributions offsets the reduced lump sum tax on end benefits.

- * If providing maximum benefits revise target benefit to reflect new reasonable benefit limits.

- * Call for actuarial recalculation of maximum permissible contributions.

Defined Benefit Plans

- * Consider reduction in future service accrual rate to offset impact of tax on employer contributions.

- * If reducing accrual rate to offset tax on employer contributions, also consider further reduction to offset estimated impact of tax on investment income.

- * If there is to be no reduction in benefit accrual rate prepare for an increase in employer contributions at next actuarial review or earlier.

- * Given that changes are required, employers with a defined benefit plan should consider whether an accumulation plan would better meet the company's needs.

HOW JACQUES MARTIN HEWITT INTERNATIONAL CAN HELP.

For existing clients your Jacques Martin Hewitt International consultant will be in contact to arrange a time to meet with your fellow Trustees to discuss the impact of these changes on your fund. If you are not a Jacques Martin Hewitt International client you can contact our office at the number listed below:-

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