Manager
Contributions and Accumulation Unit
Personal Retirement and Income Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir/Madam,

Submission on the Exposure Draft "Income Tax Assessment and Other Legislation (Sustaining the Superannuation Contribution Concession) Amendment Regulation 2013; Superannuation Contributions" *("the Regulations")*

This submission focuses on the valuation parameters specified in s 293-115.03 of the Regulations. The regulations specify a mandatory discount rate of 8% p.a. and a mandatory salary or wages growth rate of 4.5% p.a.. These are the two most significant valuation parameters in determining the amount of the defined benefit contributions in respect of a member and hence the amount if any of defined contributions subject to the Division 273 Tax.

While there may be debate about the suitability of the absolute values for the discount rate and the salary growth rate, in practice it is the gap between the discount rate and the salary growth rate which is most important. The mandatory gap specified is 3.5% p.a. and this would appear reasonable based on past medium to long term experience and expected future experience for most <u>funded</u> defined benefit funds.

A discount rate of say 7% p.a. and a salary growth rate of 3.5% (a gap of 3.5%) would give virtually the same result as the mandatory discount rates specified in the legislation. Hence provided the last actuarial review has used rates with a gap of 3.5% there would appear to be no valid reason not to use the discount and salary growth rates used in the last actuarial review to determine the defined benefit contributions under the Regulations.

Funded Defined Benefit Schemes
Specifying a mandatory gap of 3.5% will ensure that some members of defined benefit schemes will be treated preferentially under the proposed Regulations compared to other taxpayers. For example, it would not be unusual for higher income earners in senior positions to have a salary growth rate higher than applicable to average members. Furthermore some funds are likely to have a more conservative investment strategy than that underlying the 8.5% discount rate proposed in the Regulations. Hence there will be defined funds where the actuary considers it appropriate, based on the investment strategy of the fund and the experience in terms of salary growth rates, to use a gap lower than the effective 3.5% gap mandated in the Regulations, for some or all of the classes of members in the fund.

If, for example, a gap of 2.0% was considered appropriate by the actuary and used in the last actuarial review to determine the employer contribution rate the actual employer contributions for the member will be significantly higher than those calculated using the proposed mandatory 3.5% gap. Hence members of this scheme are receiving preferential treatment under the proposed Regulations.

The employer receives the benefit of a tax deduction on the <u>actual</u> contributions paid yet due to the higher *mandatory gap the employee receives the benefit of a reduced employer contribution for Division 273 tax purposes.*

The following example highlights the inequity of this situation for members of other defined benefit funds where the actuary considers a gap of 3.5% as appropriate as well as taxpayers in accumulation funds.

Example: Employees A, B and C have exactly the same salary (and for simplicity the same taxable income) of $300,000. Employee A is a member of an accumulation fund, B and C are members of defined benefit funds. Employee A receives employer contributions of 15% of salary. The contribution rates in respect of employees B & C are equal to 15% as determined in the last actuarial review for their respective defined benefit schemes and class of membership. The discount rate and salary growth assumptions at the last actuarial review are shown in the following table.

	Discount Rate	Salary Growth Rate	Gap	Employer Contributions Actual	Employer Contributions Under Regulations
E'ee B's scheme	8.0%	4.5%	3.5%	$45,000	$45,000
E'ee C's scheme	7.0%	5.0%	2.0%	$45,000	$30,000
Regulations	8.0%	4.5%	3.5%		

The amount of employee C's employer contributions under the specified mandatory assumptions will depend on age, benefits, etc. so the employer contributions of $30,000 are for illustration purposes. What is obvious is that the employer contributions for employee C determined under the Regulations will be lower than the actual employer contributions of $45,000 due to use of the specified mandatory gap of 3.5% in the Regulations compared to the 2.5% gap consider appropriate by the actuary for the defined benefit scheme at the last actuarial review. For simplicity it is also assumed there are no employee contributions. The following table illustrates the inequity of the treatment of employees A and B compared to C.

	Accumulat-ion Scheme	Defined Benefit Schemes		
	E'ee A Actual	E'ee B Actual	E'ee C Actual	E'ee C under Regulations
Employer Contributions	45,000	45,000	45,000	30,000
Concessional Contributions Cap	25,000	45,000	45,000	45,000
Excess	20,000	0	0	n/a
Excess Contributions Tax @ 31.5%	6,300	0	0	0
E'er Tax Deductible Contributions	45,000	45,000	45,000	45,000
E'er Tax deduction @ 30%	13,500	13,500	13,500	13,500
Contributions tax	6,750	6,750	6,750	6,750
Division 273 Tax	3,750	6,750	6,750	4,500
Excess Contributions Tax	6,300	0	0	0
Total Tax borne by the individual in respect of superannuation contributions	10,050	6,750	6,750	4,500
Contributions tax	6,750	6,750	6,750	6,750
Total Tax collected	16,800	13,500	13,500	11,250
Cost to consolidated revenue	-3,300	0	0	2,250
effective tax rate on contributions	37.3%	30.0%	30.0%	25.0%

In this example employees B & C received the benefit of the "grandfathering" provisions in the legislation in respect of the concessional contributions cap applying to the vast majority of members of defined benefit schemes whereas the vast majority of members of accumulation schemes receive no such benefit.

The above example clearly shows the very favourable treatment given to member C as a result of the Regulations effectively specifying a mandatory gap of 3.5% between the discount rate and the salary growth rate. The example demonstrates that for employee C if the discount rate and salary growth rate used in the previous actuarial review are used (a gap of 2.5%), the taxation treatment of employee B & C is identical as it should be.

It is clearly appropriate for the Regulations to specify a maximum gap between the discount rate and salary growth rate in order to prevent possible abuse but in my opinion it is inequitable to other taxpayers to prevent a smaller gap between the discount rate and the salary growth rate being used to determine the defined benefit contributions subject to the Division 273 tax especially if this smaller gap is considered appropriate by the actuary and has been used in the last actuarial review to determine the actual employer contribution paid.

Hence I consider that the Regulations should be changed to specify that the assumptions used in the last actuarial review for the class of member (or member) must be used for the discount rate and salary growth rate valuation parameters provided the gap between these is not greater than 3.5% p.a.. If the gap is greater than 3.5% p.a. then a discount rate of 8% p.a. and salary growth rate of 4.5% p.a. is to be used to determine the defined benefit contributions.

This modification ensures that the contributions determined under the Regulations should be very close to, if not equal to, the actual defined benefit contributions made in respect of the member and claimed by the employer as a tax deduction.

The example also illustrates how poorly members of accumulation plans are treated under superannuation legislation compared to members of defined benefit funds. It should be noted that in the above example more tax is actually collected from the employer contributions in respect of A compared to the tax deductions received. It also demonstrates that the effective tax rate after application of the Division 273 tax for someone in an accumulation fund can be much higher than the 30% claimed by the Government if employer concessional contributions in the 2012-13 income tax year exceed the $25,000 cap.

Due to "grandfathering" members of defined benefit funds can effectively receive far greater superannuation benefits via concessionally taxed superannuation funds than an identical employee in an accumulation fund due to the fact they are not subject to the concessional contribution caps. This is another obvious example of the preferential treatment given to members of defined benefit schemes. I sincerely hope that the Regulations will be amended as suggested to ensure that certain members of defined benefit schemes will not once again receive very preferential treatment compared to those in accumulation funds.

Unfunded Defined Benefit Schemes
There are very few unfunded defined benefit schemes with the majority of members covered under these schemes being parliamentarians, judges and public servants.

At the Commonwealth level these unfunded defined benefit schemes include the Parliamentary Contributory Superannuation Scheme (PCSS), the Public Sector Superannuation Scheme (PSS) and the Commonwealth Superannuation Scheme (CSS). For an unfunded scheme I consider it inappropriate to use a discount rate which is based on expected investment returns. The 8% p.a. discount rate specified in the Regulations is obviously based on expected investment returns for a funded defined benefit scheme. I also refer to the following quote from the *"PSS and CSS Long Term Cost Report 2011"* prepared by Mercer Consulting (Australia) Pty Ltd using data as at 30 June 2011.

"4.9 The assumed investment returns/ discount rate remains at 6.0% per annum (nominal). The discount rate for a funded scheme is typically based on expected investment returns in a superannuation fund. As the PSS and CSS are largely unfunded our view is that the best determination of the discount rate is the expected return on government bonds over the long term, as this would be the cost to the Australian Government were it to "fund" the schemes via borrowings. …
4.10 The assumed rate of future general salary increases remains at 4.0% per annum (nominal)…"

The 2011 Long term Cost report into the PSS and CSS assumes a discount rate of 6.0% p.a. and a salary growth rate of 4.0% p.a., i.e. a gap of 2.0%, to estimate the contribution rate that *"would be required to fund the benefits accruing to contributors over the next three years"*. However under the draft Regulations the defined benefit contributions for the Division 273 tax would be determined based on a gap of 3.5% which would have the effect of substantially reducing the contribution level for the Division 273 tax compared to that recommended under the 2011 Long Term Cost report. As highlighted in respect of the example given previously for a funded defined benefit scheme the use of a 3.5% gap for Division 273 tax purposes gives preferential treatment to members of the PSS and CSS compared to other taxpayers.

The *"Parliamentary Contributory Superannuation Scheme – Long Term Cost Report 2011"* prepared by Mercer Consulting (Australia) Pty Ltd using data as at 30 June 2011 assumed a discount rate of 6.0% and a salary growth rate of 4.0% (a gap of 2%) were appropriate to estimate the notional contributions required to fund the benefits to members.

A gap of 2%, not 3.5%, has been considered appropriate to determine the cost of:
- the PCSS at the actuarial reviews in 2011, 2008 and 2005, and
- the PSS and CSS at the actuarial reviews in 2011, 2008, 2005 and 2002.

Hence the use of a 3.5% gap as proposed in the Regulations would appear to provide preferential taxation treatment to Federal parliamentarians who are members of the unfunded PCSS compared to funded defined benefit scheme and accumulation fund members. The decision for the PCSS, the PSS and CSS to be and remain unfunded is a decision made solely by parliamentarians. It therefore appears totally inappropriate that parliamentarians should support taxation legislation that applies assumptions which are appropriate for funded defined benefit schemes especially to their unfunded PCSS scheme.

Hence the inappropriateness of using a mandatory discount rate of 8% p.a. and a salary growth rate of 4.5% (a gap of 3.5%) for unfunded defined benefit schemes also supports the adoption of the recommendation that:

The Regulations should be changed to specify that the assumptions used in the last actuarial review for the class of member must be used for the discount rate and salary growth rate valuation parameters provided the gap between these is not greater than 3.5% p.a.. If the gap is greater than 3.5% p.a. then a discount rate of 8% p.a. and salary growth rate of 4.5% p.a. is to be used to determine the defined benefit contributions.

Yours sincerely,

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