

7. The constitutional basis for Commonwealth regulation

Introduction

Scope of chapter

7.1. This chapter deals with the extent of Commonwealth legislative power to impose prudential and other controls on superannuation and related schemes. It considers a number of possible sources of constitutional power for the Commonwealth to regulate superannuation scheme operations. The objective of the discussion is to identify a legislative framework that will allow the Commonwealth to exercise appropriate regulatory control over the kinds of superannuation schemes that are operating and those that may be established in the future.

The present regulatory framework

7.2. *The framework outlined.* The *Occupational Superannuation Standards Act 1987* (Cth) (OSSA) is, together with the *Income Tax Assessment Act 1936* (Cth) (ITAA), the mechanism by which the Commonwealth presently imposes regulatory control on superannuation schemes. Under ITAA the income earned by superannuation scheme trustees in their capacity as trustees is subject to a concessional rate of tax if the Insurance and Superannuation Commissioner (ISC) has certified that the scheme is a complying fund.¹ The certificate will be issued if the trustee applies for one and the ISC is satisfied that the superannuation fund conditions, or the ADF or PST conditions, set out in OSSA and the OSS Regulations have been complied with for the year of income to which the application relates. There is power to give a certificate even if the ISC is not satisfied that the conditions have been met if special circumstances exist that justify the scheme being treated as a complying fund. This power is used extensively.²

7.3. *No effective sanctions.* The principal defect of this approach is that trustees who fail to comply with the standards fixed under OSSA are not directly subject to any penalties or sanctions. This means

1. ITAA s 23FC, 23FD; OSSA s 12, 13 for certificates.

2. OSSA s 13. The Review understands from the ISC that approximately 4,000 schemes receive tax concessions each year even though they do not comply.

- the only penalty or sanction that can be imposed for a breach of the standards — the removal of the tax concession — is necessarily imposed on the fund members rather than on the non-complying trustees, as it is the fund members' entitlements, and therefore their retirement income support, that will be reduced if the scheme's income is subject to taxation at normal rates
- the Commonwealth has no effective means to ensure that its policy objectives in relation to superannuation will be met.

7.4. *Need for new enforcement mechanism.* Clearly, a more precise and sophisticated regulatory approach is needed to enable superannuation standards to be enforced directly. The federal Government has announced that it is examining options.³ The regulator with responsibility for the implementation of Commonwealth policy in relation to superannuation needs power to penalise directly those who fail to comply with their legal obligations, rather than the members whom the regulator is, in the final analysis, working to protect. In DP 50 the Review noted that, apart from the taxation power presently used, the main alternative sources of constitutional power for the Commonwealth to legislate to regulate superannuation are

- the trade and commerce power
- the corporations power
- the pensions power.

In addition, there are a number of other relevant powers: the banking power, the insurance power, the power to make laws with respect to bankruptcy and insolvency and the Commonwealth's power in relation to its own employees and agencies and for the Territories.⁴

Sources of Commonwealth power to legislate to regulate superannuation

The taxation power

7.5. There is no doubt that the Commonwealth's use of the taxation power to regulate superannuation through the imposition of standards is constitutionally valid.⁵ A law imposing a liability for taxation can properly make the application of that law depend on whether the taxpayer has complied with standards set out or determined by reference to that law. However, if the tax law is used to

3. Treasurer's statement, paper 1 para 22.

4. DP 50 para 1.5, 1.6.

5. Constitution s 51(ii); see *Fairfax v Federal Commissioner of Taxation* (1965) 114 CLR 1.

encourage compliance with standards, as it is with superannuation, failure to comply will usually mean that there is a liability to pay tax. This encouragement to comply voluntarily is not a satisfactory way to achieve the objectives underlying the standards.

The 'trade and commerce' power

7.6. The Constitution s 51(i) authorises the Parliament to make laws with respect to

- (i) Trade and commerce with other countries, and among the States:

The superannuation industry is a national industry. Some superannuation schemes are constructed so as to engage in trade or commerce across State lines. They could be regulated by legislation under this head of power. However, the question whether individual schemes can be subject to federal regulation based on this power will have to be answered separately for each scheme. It cannot be answered on a superannuation industry wide basis. Many schemes, particularly employer sponsored schemes where the employer does not operate outside his or her home State, could not validly be the subject of federal law based on this power. The Review has concluded that the range of superannuation schemes which could validly be covered by a law based on this power would not be adequate to ensure that the Commonwealth's policy objectives for the regulation of superannuation would be met.

The corporations power

7.7. *Scope of corporations power.* The Constitution s 51(xx) provides that Parliament has the power to make laws with respect to

- (xx) Foreign corporations, and trading and financial corporations formed within the limits of the Commonwealth:

This power has recently been held by the High Court not to extend to authorising the Parliament to make a law with respect to the formation or incorporation of corporations. It is a power that can be exercised only in respect of trading or financial corporations or foreign corporations that have already been formed.⁶

6. The Full High Court has held that the word 'formed' is a 'past participle used adjectivally', thus precluding the Commonwealth from legislating with respect to the formation or incorporation of companies in Australia except in the Territories: *New South Wales v the Commonwealth* (1989) 90 ALR 355, 358.

7.8. *The national scheme for corporate regulation.* The effect of this *lacuna* has been overcome, in relation to corporate regulation generally, by agreement between State and Territory Ministers, and the federal Attorney-General, in June 1990. Under the arrangement, the administration and policy control of corporate regulation rests primarily with the Commonwealth, although amendments must be negotiated with the States and the Northern Territory. The federal Parliament has legislated exhaustively in respect of all matters of corporate regulation, including incorporation, for the ACT.⁷ Each State and the Northern Territory, under the agreement, has enacted legislation that applies the federally made law in its own jurisdiction. Amendments are enacted by the Commonwealth and take effect as a result of these State and Territory application laws. A uniform corporations law therefore applies, but as a law of each jurisdiction. The Constitutional restrictions on Commonwealth legislative power imposed by the High Court's analysis of s 51(xx) have thus been overcome in practical terms.

7.9. *Assessment of the power.* The corporations power is not adequate to allow the Commonwealth to legislate comprehensively to regulate superannuation. Principally, it does not authorise the Parliament to make a law requiring persons who run superannuation schemes to assume a corporate form. Some federal laws make it an offence to trade in particular industries otherwise than in corporate form; for example, only bodies corporate can carry on insurance business⁸ or banking business. These laws have their constitutional basis, however, not in the power to legislate with respect to trading or financial corporations,⁹ but in the powers to legislate with respect to banking and insurance.¹⁰ A corporation that conducts a superannuation scheme either as the whole or as a part of its operation would fall within the description of a trading or financial corporation. Accordingly, Commonwealth legislation could validly regulate the activities of such a corporation in relation to superannuation, at least so far as those activities were trading or financial activities.

7.10. *Implications for superannuation regulation.* While the Commonwealth could exercise policy control over the activities of corporate superannuation trustees, either through promoting amendments to the Corporations Law, or through legislating in its own right so far as the trustee body corporate is a trading or financial corporation, the Review has concluded that reliance on the corporations power will not be able to achieve fully the Commonwealth's policy objectives in this area.

7. Under the Constitution the Territories power, s 122, is not affected by the restrictions that apply in respect of s 51(xx).

8. The sole exception being for Lloyds.

9. Which the bodies corporate undoubtedly are.

10. Constitution s 51(xiii), (xiv).

The pensions power

7.11. *The pensions and social security powers.* The Constitution s 51(xxiii) and (xxiiiA) provide that the Parliament has power to make laws with respect to

- (xxiii) Invalid and old-age pensions;
- (xxiiiA) The provision of maternity allowances, widows' pensions, child endowment, unemployment, pharmaceutical, sickness and hospital benefits, medical and dental service (but not so as to authorise any form of civil conscription), benefits to students and family allowances;

A number of submissions suggested that s 51(xxiii) in particular could be an appropriate constitutional basis for Commonwealth legislative intervention.¹¹

7.12. *Social security power.* Section 51(xxiiiA) has been held by the High Court to be limited to authorising legislation that relates to a provision of benefits including widows' pensions by the Commonwealth. It does not extend to authorising federal legislation with respect to the provision of pensions by private employers or bodies.¹²

7.13. *Pension power.* Section 51(xxiii) would probably support legislation regulating old-age and invalid pensions provided by bodies other than the Commonwealth, in particular by private employers to their employees, or by life insurance companies and fund managers who promote personal superannuation schemes. There are, however, a number of problems associated with the use of s 51(xxiii). First, the meaning of the expression 'old-age pensions' is not clear. A law that made provision with respect to the operation of schemes that provide pensions to people who reach an age beyond which the community would not generally expect persons to continue to have to work in the paid workforce would probably be supported by the power.¹³ At the present time this would probably equate to 60 or 65 years. But the question is not free from doubt. A more serious problem is whether the power would authorise the regulation of schemes other than those which provide for the payment of a pension or annuity. Many schemes provide for lump sums or allow pensions or annuities to be commuted, in whole or in part. Unless the High Court were to take a broad approach that regarded the distinction between capital and income as no longer relevant, schemes that provided only for the payment of a lump sum, or which

11. eg LIFA *Submission* March 1992; ASFA *Submission* March 1992; cf P Burke *Submission* February 1992.

12. *Federal Council of the British Medical Association in Australia v the Commonwealth* (1949) 79 CLR 201.

13. See eg Quick & Garran, *Annotated Constitution of the Commonwealth* 613.

allowed unrestricted commutation of a pension, might fall outside the power.¹⁴ This may depend, in the long run, on whether the primary purpose of the scheme was the provision of an old-age pension¹⁵ and whether the terms on which lump sums were paid or commutation was permitted were incidental to and consistent with that purpose. For example, there might be provision to pay a lump sum to dependants in case of death before or after retirement, or to discharge housing loans which otherwise might be paid from the retirement income. While the direct regulation of lump sums might fall outside the power, the schemes could still be regulated in so far as they provide for pensions.

7.14. *Conclusion.* Until the matter is settled it would be wise to regard s 51(xxiii) as authorising legislation only with respect to schemes the primary purpose of which is to provide old-age pensions and which provide for the payment of lump sums only where that is incidental to the main purpose. The Review has concluded that, given the extent to which superannuation schemes provide for benefits to be taken in the form of lump sums — though there are taxation incentives to convert these lump sums into pensions — the Constitution s 51(xxiii) would not support an adequate level of regulation of superannuation funds. Some other legislative basis must be found.

Other legislative powers

7.15. *The insurance and banking powers.* The Constitution s 51(xiii) and (xiv) provide that the Parliament has power to make laws with respect to

- (xiii) Banking, other than State banking; also State banking extending beyond the limits of the State concerned, the incorporation of banks, and the issue of paper money;
- (xiv) Insurance, other than State insurance; also State insurance extending beyond the limits of the State concerned;

While these powers might seem to offer some potential for the achievement of Commonwealth policy, there are significant difficulties.

- *Exclusion of State activity.* The powers expressly exclude State banking and insurance not extending beyond the limits of the State concerned. This poses difficulties for the regulation, within the overall framework, of State superannuation schemes, that is, schemes established by State governments for their employees and officers.

14. There is authority, in a different context, for the view that a lump sum representing the commutation of a pension is not a pension, for the purpose of a law which made the pension inalienable: *Crowe v Price* (1889) 22 QBD 429 (CA).

15. Or an invalid pension.

- ***Superannuation not necessarily banking.*** The banking power is a power with respect to banking, not banks. Superannuation provided by or through banks would not necessarily be caught by the power because there are certain aspects of the provision of superannuation which fall outside banking. It would not be possible to legislate comprehensively.¹⁶
- ***Superannuation not always insurance.*** The insurance power has some associations with the provision of superannuation benefits. As chapter 2 indicates, life insurance companies are major providers of superannuation and superannuation has certain features that are similar to insurance. The Review is satisfied, however, that, for constitutional purposes, superannuation cannot be completely equated with insurance.

It is therefore not possible to rely on either the banking or the insurance power to support comprehensive federal legislation regulating superannuation.

7.16. *Bankruptcy and insolvency powers.* The Constitution s 51(xvii) authorises the Parliament to make laws with respect to

(xvii) Bankruptcy and insolvency;

Minimising the risk that superannuation schemes will be bankrupt or insolvent will be a key policy objective. However, it is not the only objective. Nor does the Review consider that the power extends to authorise all of the prudential controls that policy would demand. Many of these will be designed, not so much to prevent insolvency, as to secure the financial health of the scheme.

7.17. *The Commonwealth's power in relation to its own employees and agencies and the Territories.* The Commonwealth has complete legislative power in respect of its own public service. Under this and related powers the Commonwealth can and does establish superannuation schemes for its own employees and for employees and officers of federal agencies.¹⁷ The power does not, however, extend beyond superannuation for employees or officers of the Commonwealth. The Commonwealth also has power to make laws with

16. The Review understands that there is a proposal for banks to offer income retirement accounts which would have the effect of preserving money deposited in the fund in the same way as superannuation money is preserved.

17. Constitution s 52(ii) eg *Superannuation Act 1976* (Cth), *Judges' Pensions Act 1968* (Cth); *Parliamentary Contributory Superannuation Act 1948* (Cth).

respect to the Territories.¹⁸ While this power would support federal legislation regulating the activities of superannuation schemes that have sufficient nexus with a Territory, the power would not support national legislation.

The recommended approach

No single comprehensive power

7.18. The objective is to identify an appropriate constitutional basis for the Commonwealth to legislate fully and effectively for the achievement of its policy goals in relation to superannuation. Furthermore, it should be able to do so in a way which is more flexible than the present reliance on taxation incentives alone.

Tax incentives necessary

7.19. No Commonwealth legislative power taken alone or in combination with other powers, will completely cover the areas for which provision needs to be made. Complete coverage would be achieved only if all superannuation providers were trading or financial corporations or if all superannuation was provided in the form of old-age pensions. Commonwealth power over superannuation provided in those ways is undoubted. There is no way to compel superannuation schemes to incorporate or to provide pensions. Tax incentives are the only practicable means to induce scheme operators to arrange their schemes so as to fall within Commonwealth legislative power. The only exception should be in respect of schemes that have a single member.

Recommendation

7.20. Accordingly, the Review recommends that tax incentives remain an essential element in the regulatory scheme and that Commonwealth income taxation concessions should only be granted to schemes that bring themselves clearly within Commonwealth legislative power. In order to attract such concessions, the trustee for such a scheme should have to have been, during the relevant year of income, a foreign corporation or a trading or financial corporation formed within the limits of the Commonwealth. Alternatively, the substantial or dominant purpose of the scheme should be to offer old-age pensions. Schemes which do not meet either of these conditions should only attract taxation concessions if, during the relevant year of income, they had no more than one contributing member and fulfilled all the other conditions currently, or about to be, imposed on superannuation schemes.

18. Constitution s 122.

Recommendation 7.1. Constitutional framework

The law should provide that the conditions under which a superannuation fund an ADF or a PST attract taxation concessions include a condition that, at all times during the relevant year of income, there was a responsible entity for the fund, ADF or PST and that:

- the responsible entity was a foreign corporation within the meaning of the Constitution s 51(xx) or a trading or financial corporation within the meaning of that paragraph or
- in the case of a superannuation fund, the substantial or dominant purpose of the fund was to provide old-age pensions within the meaning of the Constitution s 51(xiii).

Consequences

7.21. The recommended approach will require significant changes to the regulatory framework, in particular OSSA and the OSS Regulations. In some cases the appropriate sanction will be the removal of the taxation concession, as is presently the case. In other cases, a contravention should amount to an offence. Again, a contravention could make the trustees of the fund liable in damages to the members of the fund who suffered a loss thereby. Each recommendation in this report indicates what sanction should be imposed for contravention of the recommended rule.