

# A recent history of superannuation in Australia

This article details the history of superannuation in Australia from the mid-1980s to the present day. There is particular focus on developments and changes in the coverage, regulation and taxation of superannuation in what has been a defining period for retirement income policy in Australia<sup>1</sup>.

## Superannuation coverage

### Award superannuation

While superannuation as a form of savings has existed for more than a century in Australia, for most of the time it applied to a minority of employees, generally higher paid white collar staff in large corporations, employees in the finance sector, public servants and members of the Defence Force. However, from the 1970s superannuation started to become more widely available as a result of claims lodged in the industrial relations arena.

The advent of institutionalised employee superannuation began in September 1985 when the Australian Council of Trade Unions (ACTU), as part of its National Wage Case claim with the Conciliation and Arbitration Commission, sought a three per cent employer superannuation contribution to be paid into an industry fund. The Government supported the claim in pursuit of its inflation control objectives and, in February 1986, the Commission announced that it would approve industrial agreements that provided for contributions of up to three per cent to approved superannuation funds. The superannuation funds approved by the Commission were generally multi-employer industry funds jointly sponsored by trade unions and employer associations.

New industrial awards were progressively negotiated under the guidelines established by the 1986 National Wage Case. Consequently, superannuation coverage rapidly increased from around 40 per cent of employees to 79 per cent in the four years following the Commission's decision. Coverage in the private sector grew from 32 per cent in 1987 to 68 per cent in 1991.

In spite of the rapid growth in superannuation coverage, award-based superannuation had a number of problems:

- nearly one third of private sector employees remained uncovered by 1991;
- not all employees who were entitled to award superannuation received it, in part because compliance could only be enforced through a laborious case mounted with the Conciliation and Arbitration Commission;
- award superannuation as a universal entitlement did not effectively take into account the significant number of employees who already had some superannuation rights as part of their employment; and

<sup>1</sup> This article is in part based on a 2001 paper issued by the Commonwealth Treasury entitled *Towards higher retirement incomes for Australians: a history of the Australian retirement income system since Federation*. The paper was included in the 2001 Centenary Edition of Economic Roundup.

- the three per cent award was too small to provide a significant improvement in retirement incomes for many employees.

The compliance problems associated with award superannuation prompted the Industrial Relations Commission in 1991 to reject an application, supported by both the ACTU and the Government, for a further three per cent of salary in award superannuation. The Commission recommended that the Government convene a national conference on superannuation involving all relevant parties to consider issues such as non-compliance; the extension of award superannuation to all awards, including state awards; building more flexibility into award-based superannuation; the extension of superannuation to casual and part-time employees; and the role of the Commission in ensuring appropriate levels of retirement income.

### Superannuation guarantee

The Government did not adopt the Commission's recommendation for a national conference and instead announced that from 1 July 1992, under a new system to be known as the superannuation guarantee, employers would be required to make tax-deductible superannuation contributions on behalf of their employees. Employers who did not provide the required amount of superannuation support would be liable for a non-deductible Superannuation Guarantee Charge, equivalent to the individual employee shortfall in contributions, an interest component and an administrative charge.

The superannuation guarantee, enforceable through the Commonwealth's taxation powers, provided for:

- a major extension of superannuation coverage to employees not already covered by superannuation;
- an efficient method of encouraging employers to comply with the obligation to make contributions on behalf of their employees; and
- a mechanism by which the level of employer superannuation support could be increased over time, consistent with the Government's retirement income policy objectives and the economy's capacity to pay.

The superannuation guarantee commenced in 1992/93 with employer contributions of three per cent of salary (four per cent for employers with an annual payroll greater than \$1 million). Higher levels of contributions

were phased-in over a ten-year period and reached the maximum of nine per cent in 2002/03. Initially contributions were required to be paid annually in arrears; this was changed to quarterly in arrears from 1 July 2003. This change benefited employees in two main ways – employer contributions could be invested sooner and the incidence of unpaid employer contributions as a result of employer insolvency would be likely to be lower.

The superannuation guarantee used broad definitions of employer and employee and provided very few exemptions, the most prominent being for employees earning less than \$450 per month, part-time employees under 18 years of age and employees aged 65 or over. From 1 July 1997 the Government extended the upper age limit for superannuation guarantee contributions from 65 to 70 years, thereby encouraging the increasing tendency for older Australians to work past normal retirement age. This higher age limit for contributions also applied to non-mandatory employer contributions and personal contributions provided that the member was gainfully employed for ten hours or more each week.

### Choice of fund

The superannuation guarantee legislation did not specify any particular fund to which employers should make their mandatory contributions, beyond the requirement that the fund be a 'complying fund' for the purposes of the *Superannuation Industry (Supervision) Act 1993* (the SIS Act). Where employees were covered by award superannuation, the award generally nominated an industry fund as the fund to receive the three per cent award contribution. An employer was free to pay the balance of the superannuation guarantee contribution in excess of the award contribution into any complying fund selected by the employer. In practice, for administrative simplicity employers often paid the entire superannuation guarantee contribution into the industry fund that received the award contribution.

Legislation amending the superannuation guarantee to allow employees to choose the fund which receives their superannuation guarantee contributions was first introduced into Parliament in December 1997. Agreement on the way in which choice of superannuation fund would operate was not reached for some years and it was not until towards the end of 2003/04 that amending legislation was passed. The original amending legislation put forward in 1997 allowed employees to

choose from among five funds selected by their employer. In the final form of the legislation, which came into effect on 1 July 2005, employees are generally able to nominate any complying fund into which the employer pays superannuation guarantee contributions. Employers select a default fund which applies where employees do not nominate another fund. As many employees may be inclined to accept the default fund selected by the employer, superannuation trustees and their related parties are generally prevented from offering inducements to employers for their employees to become members of a particular superannuation fund.

Amended portability of benefits provisions in the SIS regulations effective from 1 July 2005 complement the choice of fund arrangements and require trustees to transfer a member's accumulation withdrawal benefit to another fund on the request of the member.

### Problems with small accounts and lost members

As the superannuation guarantee made superannuation more widely available, in particular to low-income, part-time and casual workers, the impact of fund fees and charges on small account balances became more noticeable. In response, the Government introduced, from 1 July 1995, member protection rules which prevented fund fees and charges on accounts with balances of less than \$1,000 from exceeding any investment gains in those accounts. The Government also established a small accounts collection system within the Consolidated Fund, the Superannuation Holding Accounts Reserve, to accept superannuation guarantee amounts from employers where the employer was unable to locate a superannuation fund that would accept small or one-off superannuation contributions. This system was later discontinued as funds willing to accept small contributions and offer member protection became more widely available.

An indirect effect of mandatory superannuation has been an ongoing increase in the number of member accounts. At 30 June 2006 there were 29.1 million member accounts, a significant increase from the 16.3 million accounts at 30 June 1996. The increase in the number of superannuation accounts is partly attributable to employees joining a new (default) superannuation fund as they change employment. Choice of superannuation fund and easier portability arrangements may see a lessening in the growth of superannuation accounts.

Approximately five million superannuation accounts belong to members with whom the trustee has lost contact – these members are known as 'lost members'. A Lost Members Register, maintained by the Australian Taxation Office (ATO), was established in 1999 to assist these members locate their accounts and consolidate their superannuation. Superannuation funds are obliged to report lost members to the ATO on a regular basis. The more widespread use of tax file numbers for superannuation purposes (encouraged through significant tax incentives) should assist in reducing the number of lost member accounts. The ATO will also play a more active role in contacting lost members and assisting them consolidate their accounts as part of the superannuation simplification plan announced with the Budget in May 2006.

### The superannuation guarantee and defined benefit funds

Defined benefit funds provide members with a pre-determined benefit generally based on the member's final salary and length of service with the employer-sponsor of the fund. The employer-sponsor is responsible for financing the pre-determined benefit (to the extent it is not funded by member contributions) and therefore bears the residual risk associated with investing the fund's assets.

Prior to award superannuation, most members were in defined benefit funds; for example, in 1982/83, 82 per cent of fund members were covered by defined benefit funds. Generally, the industry funds established to accept award (and, later, superannuation guarantee contributions) were accumulation funds. The administrative complexity of defined benefit funds compared to accumulation funds made them less attractive for employers to use to satisfy their superannuation guarantee obligations. Other reasons for the decline in defined benefit funds are their typically higher and uncertain costs that with the passage of time could overshadow corporate balance sheets. By 2005/06, 97 per cent of members were in funds that provided either accumulation benefits or a mixture of accumulation benefits and defined benefits.

A key difference between defined benefit and accumulation funds is that accumulation fund members bear the investment risk since, over time, all investment earnings and losses are credited or debited to member accounts. Members may be offered a choice

of investment options. This shift of investment risk to members and away from employers is a central feature of the decline in defined benefit funds both in Australia and overseas.

### The superannuation guarantee and the public sector

While all levels of government in Australia had a long tradition of providing retirement benefits for their employees, public sector superannuation was generally provided through unfunded or partially funded arrangements whereby the cost of benefits was met at the time the benefits were paid rather than as the benefits were accrued. The introduction of mandatory superannuation through the superannuation guarantee had the effect of setting a widely accepted standard for employer-funded superannuation for all employers, including public sector employers. In response to the superannuation guarantee and a growing concern with unfunded superannuation liabilities against the projections of an ageing work force, governments closed their unfunded or partially funded defined benefit schemes to new members and established fully funded accumulation schemes to provide new employees benefits at the level of the superannuation guarantee or higher.

The Australian Government announced in the 2005/06 Budget that it would create the Future Fund, with the defined purpose of accumulating sufficient financial assets to offset the Australian Government's unfunded superannuation liability by 2020.

### Regulation of superannuation

Most superannuation in Australia is provided through a trust structure where trustees hold the superannuation assets on trust on behalf of members and owe a fiduciary duty to those members. Trustees have a duty to act in the best interest of members while managing the superannuation savings in their care.

A condition of the Conciliation and Arbitration Commission's 1986 National Wage Case decision was that industry superannuation funds would be required to conform to the Commonwealth's operational standards for superannuation.

*The Occupational Superannuation Standards Act 1987 (OSSA)* prescribed operating standards for:

- the vesting of benefits arising from employer and employee contributions;
- the preservation of superannuation benefits within the superannuation system until age 55;
- greater member involvement in the control of superannuation funds (e.g. through equal representation of employees and employers on the trustee board of superannuation funds with 200 or more members); and
- the security of members' benefits (e.g. requirements that funds seeking taxation concessions lodge with the newly established Insurance and Superannuation Commission annual returns certifying compliance with relevant provisions).

### Superannuation Industry (Supervision) Act

With the mandating of superannuation contributions through the superannuation guarantee in 1992, the Government sought to build community confidence in the superannuation system and to ensure that monies contributed to superannuation were managed to maximise retirement benefits.

Superannuation funds that complied with the OSSA legislation received a compliance notice entitling them to concessional taxation. To facilitate more effective supervision, the Government decided that tax concessions would only be granted to superannuation funds which the Commonwealth was able to directly regulate under its corporations or pensions powers (in addition to its taxation power). This meant that the trustee of the superannuation fund needed to be a corporation within the meaning of the Constitution or the fund had to have as its substantial or dominant purpose the provision of age pensions within the meaning of the Constitution. Under this approach trustees could be subject to a range of civil and criminal penalties without the need to make a fund non-complying for taxation purposes (which would punish the beneficiaries already affected by the unsatisfactory management of the fund).

The SIS Act replaced the OSSA legislation from 1 July 1994. The SIS legislation included measures which:

- required superannuation trustees electing to be regulated to be subject to the Commonwealth's corporations or age pensions powers under the Constitution;

- set out the basic duties and responsibilities of trustees and ensured that they had adequate powers to carry out these responsibilities;
- improved disclosure and regulatory reporting requirements;
- enlarged the roles performed by auditors and actuaries; and
- introduced more direct enforcement powers and improved audit resources for the Insurance and Superannuation Commission.

The Commonwealth Government did not seek to directly regulate the superannuation schemes of the States and Territories and instead entered into a Heads of Government Agreement in 1996 whereby it was agreed that the public sector schemes covered by the agreement would be operated in accordance with the Commonwealth's retirement incomes policy. These schemes, known as Exempt Public Sector Superannuation Schemes, were treated as complying superannuation funds for superannuation guarantee and taxation purposes.

An alternative to trustee-controlled superannuation funds was introduced in June 1997 by the *Retirement Savings Accounts Act 1997*. Retirement savings accounts (RSAs) are able to be offered by banks, credit unions, building societies and life offices outside a trust structure. Retirement savings accounts were intended as a low-cost, capital protected, alternative to superannuation accounts for small balances that could be rolled over into traditional funds after savings had been built up. RSAs could also serve retirees with little risk appetite, seeking cash investments.

### Retirement incomes policy

The SIS legislation has continued to be amended to reflect ongoing developments in the Commonwealth's retirement incomes policy.

The preservation rules were strengthened with effect from 1 July 1999 to require all superannuation contributions and all investment earnings accruing from that date to be preserved until a member's preservation age. A phased increase in the preservation age from age 55 to age 60 has also been legislated; however, this change will not be take full effect until 2025 to minimise its impact on the retirement planning of older employees.

Provisions allowing the splitting of superannuation between divorcing or separating spouses by agreement or by Court order came into force on 28 December 2002. Splitting of contributions between spouses as the contributions are made has also been permitted for contributions made after 1 January 2006 (from April 2007 onwards, spouses are able to split only taxable contributions).

The contribution rules for superannuation were simplified from 1 July 2004 to allow a superannuation fund to accept contributions in respect of a person under the age of 65 without regard to whether the person was gainfully employed (the membership of non-public offer funds remained restricted to employer-sponsored members, their spouses and children under the age of eighteen – the latter two categories having been added in the period since 1996). A work test continued to apply for members between the ages of 65 and 75 but the test was rationalised to require only that a member had worked for 40 hours within a 30 day period in the financial year in which contributions were paid. In 2002 the maximum age for personal contributions was extended from 70 to 75; from 1 July 2007, non-mandated employer contributions are also been permitted up to age 75.

The compulsory cashing rules (which required benefits to be paid to members over the age of 65 when they ceased to meet the work test or when they attained age 75) were also simplified in 2004 and then abolished with effect from May 2006.

To encourage older employees to remain in the workforce, a new category of benefit called a transition to retirement pension was permitted from 1 July 2005. Transition to retirement pensions assist an employee to move from full-time to part-time employment as they do not require employment be terminated before a pension can commence. Restrictions on commutation prevent the cashing of lump sums prior to retirement.

The SIS rules governing annuities and pensions were amended from 1 July 2007. Among other changes, the minimum drawdown rules for account-based pensions were simplified and the maximum drawdown rules removed. As a consequence of these changes, the previous distinction between cashing benefits as a pension or as a lump sum has been blurred and, given the tax advantages of pension phase, more members are likely to be classified as recipients of a pension in the future.

## Financial System Inquiry

The Government announced on 30 May 1996 the establishment of an Inquiry into the Australian financial system to report by 31 March 1997. The Inquiry was directed to assess the financial deregulation of the Australian financial system since the early 1980s, analyse the forces driving change and make recommendations on the nature of the regulatory arrangements that would best ensure an efficient, responsive, competitive and flexible financial system consistent with financial stability, prudence, integrity and fairness. The major recommendations of the Financial System Inquiry were:

- the establishment of the Australian Prudential Regulation Authority (APRA), as an integrated prudential regulator to supervise the banking, insurance and superannuation sectors of the financial services industry;
- the establishment of the Australian Securities and Investment Commission (ASIC) to cover market integrity, disclosure and other consumer protection issues across the entire financial services industry; and
- the focussing of the role of the Reserve Bank of Australia (RBA) on the objectives of monetary policy, overall financial systems stability and regulation of the payments system.

The Government accepted these recommendations.

APRA commenced operation on 1 July 1998 and took over the supervisory functions of the discontinued Insurance and Superannuation Commission. Under the ‘twin peaks’ model of financial regulation, the SIS provisions relating to disclosure and market conduct became the responsibility of ASIC. The disclosure provisions in the SIS legislation were subsequently transferred to the *Corporations Act 2001* and regulations.

Another recommendation of the Financial System Inquiry endorsed by the Government concerned the regulation of self-managed superannuation funds (SMSFs) – funds where the trustees were the only members of the fund. Self-managed superannuation funds were previously called ‘excluded funds’ and, amongst other reasons, were established to allow the self-employed and small businesses to establish and manage their own superannuation accounts.

The SIS Act was amended in 1999 to establish a new category of small superannuation fund to be regulated by the Australian Taxation Office. In general, a less onerous regime was imposed on SMSFs because all members were directly involved in the management of the fund and therefore were better able to protect their own interests. In addition to continuing to require the fund to have fewer than five members, the SIS amendments required all members of the fund to be trustees of the fund or directors of the body corporate trustee. Employees could not be a member of their employer’s self-managed superannuation fund except where they were a relative of the employer.

## Superannuation Working Group

On 2 October 2001 the Government released an Issues Paper *Options for Improving the Safety of Superannuation* which raised a number of proposals for the supervision and governance of superannuation entities. A superannuation working group, comprising representatives from the Treasury, APRA and ASIC under the chairmanship of a retired senior executive from the financial services sector, was established to conduct consultations on the Issues Paper proposals and to develop legislative options to put to the Government. The Superannuation Working Group presented its final recommendations for legislative change in October 2002, most of which were accepted by the Government and subsequently enacted through the *Superannuation Safety Amendment Act 2004*.

The major changes affecting APRA-regulated superannuation entities as a result of the Issues Paper and the recommendations of the Superannuation Working Group were:

- trustees were required to be licensed by APRA by 30 June 2006 if they wished to remain as trustees of APRA-regulated superannuation entities;
- a mandatory risk management framework would apply for both the trustee and the funds under trusteeship; and
- new operating standards covering fitness and propriety, adequacy of resources and outsourcing would also come into effect.

The licensing of APRA-regulated trustees had also been recommended by the Productivity Commission in its April 2002 report on the SIS Act and other superannuation legislation. Licensing of superannuation trustees reflected the arrangements already applying in other industries regulated by APRA and was an indication of the significant development of the superannuation industry away from its original base in company-specific funds and public sector schemes.

The APRA-issued licence for superannuation trustees differed from the Australian Financial Services Licence (AFSL) regime administered by ASIC. The AFSL requirements were introduced in 2002 and generally governed the conduct of financial advisors and financial product issuers. While all superannuation trustees regulated by APRA are required to hold an APRA licence, only those superannuation trustees undertaking certain business activities, such as providing financial advice or being a trustee of a public offer superannuation fund, are required to hold an AFSL.

The introduction of licensing accelerated the existing trend for rationalisation and consolidation in the superannuation industry and over the two-year transitional period the trustees of many stand-alone corporate funds decided to wind up the funds and transfer the membership to other funds, such as mastertrusts operated by licensed trustees.

## Taxation of superannuation

Superannuation has always been a preferentially taxed savings vehicle. Up until 1983 the tax position for most employer superannuation funds was broadly as follows<sup>2</sup>:

- employee contributions may qualify for a rebate;
- employer contributions were generally deductible;
- the investment income of the fund was generally not taxed if the fund was approved and maintained in accordance with taxation legislation;
- the entire amount of pension benefit was treated as assessable income; and
- an amount equal to five per cent of a lump sum benefit was included in assessable income.

The Government's May 1983 Economic Statement announced that tax would be levied on the taxable component of lump sums at the rate of 30 per cent (if received at age 55 or later, the first \$50,000 attracted a tax rate of 15 per cent). These arrangements applied only to lump sum amounts relating to service after 1 July 1983. The existing taxation arrangements were grandfathered for benefits that related to service prior to this date.

From 1 July 1988, a 15 per cent tax was applied to all employer contributions and deductible member contributions received by superannuation funds, while the tax on end benefits was correspondingly reduced. A 15 per cent tax also applied to the investment income of superannuation funds derived from 1 July 1988. The tax on investment earnings could be offset by the allowance of full imputation credits for franked dividends received from Australian companies and credits for dividend and interest withholding tax on income received from foreign sources (the latter quarantined to foreign income).

To avoid the imposition of a new tax on a retrospective basis, the taxation treatment of the pre-1983 component of retirement benefits and amounts accumulated between 1 July 1983 and 30 June 1988 remained unchanged. Grandfathering of this nature added to the complexity of superannuation taxation arrangements.

To the extent that Exempt Public Sector Superannuation Schemes had funds which paid tax, the schemes were treated as complying funds for taxation purposes and members' benefits were taxed accordingly.

The complexity of superannuation taxation also increased as a result of the introduction of new Reasonable Benefit Limits (RBLs) from 1 July 1988. The purpose of RBLs was to limit the taxation concessions for high income earners by subjecting benefits received in excess of an individual's RBL to marginal rates of tax. Prior to 1 July 1988, a superannuation fund was able to provide a lump sum of up to seven times salary or a pension of up to 75 per cent of salary regardless of the level of salary a person was paid. The RBL system reduced the maximum percentages of lump sum and pension benefits as the level of salary increased. The pension RBL was approximately double the lump sum RBL, giving an incentive to take

<sup>2</sup> E S Knight and others, *Superannuation Planning in Australia*, Third Edition: CCH Australia Limited 1982.

at least 50 per cent of benefits in the form of complying pensions. In practice, however, the benefit entitlements of most members, particularly those funded only by the superannuation guarantee, would be unlikely to exceed the lump sum RBL.

The administration of the RBL system required that funds submit an RBL Notification to the Australian Taxation Office whenever a benefit was paid. The ATO, in turn, was required to maintain lifetime records of superannuation benefits in order to assess whether the aggregate benefits an individual received exceeded the individual's RBL. From 1 July 1994, in an attempt to reduce administrative complexity, the pension and lump sum RBLs changed to flat dollar amounts which applied to all members (other than those with higher grandfathered entitlements known as transitional RBLs) and were indexed annually.

In 1996 the Government introduced a surcharge on superannuation contributions made in respect of high-income earners. Under the scheme, a surcharge of 15 per cent was imposed on employer superannuation contributions made after 20 August 1996 on behalf of individuals with an income (including deductible superannuation contributions) of \$85,000 or more. The surcharge was phased in over an income range of \$70,000 to \$85,000, to be indexed annually. Surcharge also applied to defined benefit and unfunded schemes. The surcharge rates were reduced in the 2003/04 financial year and the surcharge itself was abolished with effect from 1 July 2005.

The current Government policy has been to not increase the level of mandatory superannuation beyond the nine per cent superannuation guarantee. While additional superannuation has been regarded as a matter for individuals to determine in the light of their personal circumstances, the Government has provided significant financial incentives to encourage voluntary contributions.

The Government introduced, from 1 July 1997, an 18 per cent rebate for up to \$3000 of contributions made by individuals on behalf of their low-income spouse. This measure was designed to be of particular benefit to women outside the paid workforce who were not covered by the superannuation guarantee.

Since 2003/04, Government co-contributions have been available for low and middle-income earners who make contributions from their after-tax income.

A maximum co-contribution of \$1,500 applies where a person on an income of \$28,000 or less makes an after-tax contribution of \$1,000. The amount of the co-contribution phases down as income increases and ceases to be payable at incomes of \$58,000 or more. While ineligible for the co-contribution, higher income earners often have a capacity to make salary sacrifice contributions whereby they exchange salary (taxed at marginal rates) for higher employer superannuation contributions (taxed at the rate of 15 per cent).

In its May 2006 Budget, the Government announced its plan to simplify superannuation and these measures have now come into effect. The complexity of taxation of superannuation benefits has been reduced through the removal of tax on pension and lump sum benefits paid after age 60 (benefits paid from untaxed funds incur reduced tax). The RBL system used for limiting the amount of concessional taxation has been discontinued. In future, the amount of concessional taxation advantages available to individuals will be controlled through standard limits on all contributions made to superannuation funds in a financial year in respect of a person. All contributions are reported to the ATO which will levy an excess contributions tax where the standard limits have been breached. Tax file numbers will be used as the major mechanism by which compliance with the annual limits is monitored.

The age-based limits on tax deductibility of employer contributions have been abolished in favour of standard limits which will be periodically updated. The general effect of this change is to increase the maximum level of deductible contributions at younger ages and reduce it at older ages.

Under the simpler superannuation measures, more flexibility is available as to when benefits are taken (they no longer need to commence by any particular age or employment status). Where benefits are taken as an account-based pension, the upper limits on the amount of pension that can be paid in a financial year have been removed.

The simpler superannuation measures can be expected to affect both member behaviour, in terms of saving, withdrawal and estate planning, and trustee operations including investment strategy, liquidity management and marketing.